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Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1985

RALPH MICHAELS, EVERETT B. MICHAELS
AND EVRA CORPORATION
(HYMAN-MICHAELS COMPANY), *Petitioners,*

vs.

JOSEPH MICHAELS, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

The decision by the Seventh Circuit in this case creates intractable new rules of law relating to disclosure requirements and materiality under Rule 10b-5. These rules are incompatible with the decision of this Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), in conflict with decisions in the Second, Third, Sixth, Eighth and Ninth circuits as well as the Securities and Exchange Commission, and raise important issues central to the laws governing securities transactions. Two fundamental legal questions are raised by the decision below.

1. Can liability under Rule 10b-5 be based on a failure to disclose preliminary premerger conduct where (a) there is no likelihood that a merger will occur, (b) there have been no negotiations between the potential buyer and seller, let alone agreement as to the price and structure of the transaction, and (c) the ultimate merger parties are not even aware of each other's identity. Put more broadly, what degree of probability of completion must premerger activities have before they become material and must be disclosed.

2. Can there properly be two separate rules as to materiality and disclosure requirements under Rule 10b-5, one for so-called "private" companies and another for "publicly traded" companies; and as a corollary, is there any principled way for courts to make the Seventh Circuit's public-private distinction?

RULE 21(b) STATEMENT

The parties to the case are respondent/plaintiff Joseph Michaels, his uncles, petitioners/defendants Ralph Michaels and Everett B. Michaels, and petitioner/defendant the Hyman-Michaels Company, which after the sale of assets at issue herein, became known as Evra Corporation. The Securities and Exchange Commission ("SEC") participated in the rehearing proceedings before the Seventh Circuit as amicus curiae. Azcon Corporation, the eventual buyer of certain assets, was dismissed as a defendant below.

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OPINIONS BELOW

The United States Court of Appeals for the Seventh Circuit's first opinion (July 3, 1985) is reported at 767 F.2d 1185 and is set forth in the Appendix at App. 33a. The second opinion (amended in response to the SEC's amicus brief) in which rehearing was denied, was rendered on September 9, 1985, is not yet reported, but appears in the Appendix at App. 3a. The district court opinions, all of which are unreported, are reproduced in the Appendix as follows: order denying defendants' motion for hearing on their counterclaims and granting plaintiff's motion for directed verdict on defendants' counterclaims (4/13/84), App. 65a; opinion denying defendants' motions for judgment notwithstanding the verdict and, in the alternative, for new trial (3/23/84), App. 68a; opinion on reconsideration of summary judgment ruling (12/15/82), App. 79a; and opinion denying defendants' motion for summary judgment (7/15/82), App. 84a.

JURISDICTION

On July 3, 1985, the Seventh Circuit entered judgment affirming the district court's judgment against petitioners. On July 17, 1985, a timely petition for rehearing with suggestion of rehearing in banc was filed, and on September 9, 1985, after consideration of respondent's answer to the petition for rehearing and an amicus brief submitted by the SEC, the Seventh Circuit issued an amended opinion which also denied the petition for rehearing. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

Section 10(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78j

Rule 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5

STATEMENT OF THE CASE

Preliminary Statement

The important issues of securities law raised by this petition begin with the purchase by Hyman-Michaels Company ("Company") of the 14% of the Company's stock then owned by plaintiff/respondent, Joseph Michaels ("Joseph"), under an agreement signed by all parties on January 27, 1976. The defendants/petitioners are the Company itself and its two controlling shareholders, Joseph's uncles Everett Michaels ("Everett") and Ralph Michaels ("Ralph"). At the time in question, Everett owned or controlled 50% of the outstanding Company stock; Ralph 36%. Joseph, Ralph and Everett all were full-time officers and directors of the Company, which was engaged in the scrap metal, ocean shipping and related businesses.

Joseph brought suit under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j, and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, which are the general antifraud provisions under the Exchange Act. Jurisdiction was invoked in the district court under 15 U.S.C. §78aa and principles of pendent jurisdiction.

Although the case was tried to a jury, virtually all of the facts were stipulated to before trial. Joseph's case hinges on allegations of an omission and a misstatement in connection with the sale of his stock to the Company. Joseph claimed that at that time, Everett and Ralph knew, but failed to tell him, that on January 24, 1976, three days before, Ralph had met with someone who aspired to act as a broker regarding a possible sale of the Company.[1] Joseph also claimed that on January 5,

[1] The Seventh Circuit concluded that Ralph actually retained the broker on January 24. (Slip at 14, App. 16a. Unless otherwise indicated, all references to the Seventh Circuit's opinion are to the amended opinion of September 9, 1985.) While we vigorously dispute such conclusion, the resolution of this issue one way or the other does not change the analysis.

1976, Ralph misstated the status of certain loan negotiations between the Company and the Continental Illinois National Bank and Trust Company of Chicago ("Continental" or "Bank") by saying that the Bank had said "no" to a $4 million loan request by the Company when, in fact, the Bank had said only that no loan could be made without Ralph's personal guarantee, which the whole family knew Ralph would not give. This suit was filed because some six months after Joseph sold his stock on January 27, 1976, most of the Company's metals business assets, but not the shipping business, were sold to a third party at a price which Joseph contended resulted in Ralph and Everett realizing more for their stock on a per/share basis than the $300 (i.e. approximately $1 million) that Joseph asked for and received for his. Joseph maintained that had he known of Ralph's meeting with the broker or understood the "true" state of affairs regarding the Bank negotiations, he would not have sold his stock.

Joseph brought suit in 1978. The case was tried to a jury which in November, 1983, returned a verdict against petitioners. The district court denied petitioners' motions for new trial and for judgment notwithstanding the verdict. This petition seeks review of the Seventh Circuit's affirmance of the judgments against petitioners under the securities laws which, including prejudgment interest, post-judgment interest, punitive damages and costs, now exceed $1.5 million.

Factual Background

Everett, Ralph and Joseph had been trying to sell the Company since at least 1966 and had negotiated unsuccessfully with at least ten potential buyers. The last negotiations before Joseph sold his stock occurred in the summer of 1975 between Hyman-Michaels and the Commercial Metals Company ("Commercial Metals"). While those negotiations were ongoing, there was a meeting with two representatives of another company, International Carbon and Minerals Corpo-

ration ("ICM"), also regarding a possible sale of the Company. One of the ICM representatives was Angus Littlejohn ("Littlejohn"), a consultant to ICM residing in London and an old friend of Ralph's. Before serious negotiations with ICM could get underway, Ralph terminated the discussions, stating that he would get back in touch if the Commercial Metals negotiations fell through, which, in December of 1975, they did. Joseph knew about both Commercial Metals and ICM.

Since the Commercial Metals deal would have allowed Everett, who was then 72 years old and extremely ill, to put his estate in order by liquidating his Hyman-Michaels stock, everyone was disappointed when the deal collapsed. As a result, Ralph and Joseph decided that the Company should buy Everett's 50% interest. Everett, Ralph and Joseph agreed that $300 per share was the right price. In order to buy Everett's stock, it would be necessary for the Company to borrow about $3 million from the Continental.

While Ralph was negotiating the loan for the Company to buy Everett's stock, Joseph and his lawyers decided that he wanted to have his 14% minority interest bought at the same $300 per share which majority shareholder Everett expected to receive. Joseph threatened to veto the Company's buyout of Everett unless this occurred. Ralph felt the Company could not afford to borrow the additional $1 million it would take to buy Joseph's stock and was upset at Joseph's threat to veto the proposed buyout of Everett. However, he agreed to ask the Continental to lend more money, telling Joseph that he thought the request could "kill" the whole deal, i.e., both the proposed buyout of Everett and Joseph's "piggyback" demand. He also said that regardless of whether the whole $4 million could be obtained, the Company *would* do everything it could to buy Joseph's stock for $1 million, at which time Joseph would be "out", i.e. discharged from his vice-presidency with the Company.

When Ralph met with the Continental on January 5, 1976, the Company's request for an extra $1 million had roughly the effect Ralph predicted. The Bank, which had previously been positive about the $3 million unsecured loan, became reluctant, and advised that unless Ralph would personally guarantee the whole $4 million now being requested, it was unlikely that any loan could be made. However, the Bank reminded Ralph that if the Company merely wanted to buy out Joseph, it could use its normal line of operating credit for which no special approval would be needed. Ralph, under no obligation to provide a guarantee and firmly opposed to providing one,[2] concluded that the negotiations for the $4 million loan were going nowhere. As a result he and Everett decided on January 5, 1976, to have the Company buy out Joseph using the Company's line of credit.[3]

Later in the day on January 5, Ralph relayed to Joseph that the "bank said 'no' " and reaffirmed that Joseph's stock would be purchased at the price Joseph asked for. Ralph also reaffirmed that Joseph's employment was terminated, as Joseph had been forewarned by his own lawyer when he first demanded to be bought out.

In mid-January, while Joseph's and the Company's attorneys were working out the details of Joseph's stock sale, Ralph went to Europe on other Company business. While in London, Ralph called his friend Littlejohn (the ICM consultant) and, after stating that the Commercial Metals negotiations had fallen through, Ralph asked whether ICM still had any interest in acquiring the Company. Littlejohn said he

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[2] Years before, Ralph and Everett had personally guaranteed a Company loan. In view of the problems which resulted, Ralph vowed tc all the family never to give a personal guarantee again.

[3] Ralph was right about the negotiations for the larger loan. They continued to sputter for some time, but eventually no loan was made.

would like to discuss the matter and they set up a lunch meeting for the next day, Saturday, January 24.[4]

At the lunch, which also was attended by Littlejohn's wife, a great variety of things were discussed, among which was the fact that Littlejohn claimed to know of a number of companies who might be interested in buying Hyman-Michaels. It is undisputed that these were only "theoretical possibilities" and the name Consolidated Gold Fields ("Gold Fields") mentioned by Littlejohn meant nothing to Ralph. Ralph returned to Chicago on January 25 with the understanding that Littlejohn would try to contact some of his "theoretical possibilities" to see if any of them had an interest in acquiring the Company. It is stipulated that Littlejohn had no idea whether these "possibilities" would be interested in or able to afford such an acquisition.

Meanwhile, Joseph's lawyer and the Company's lawyer had set the closing of Joseph's stock sale for Tuesday, January 27, 1976. The parties have stipulated that January 27 is the controlling date for purposes of disclosure and liability. The closing went off smoothly and it is undisputed that as of that time, there had been no negotiations between Ralph or anyone else connected with the Company and any potential purchaser of any or all of Hyman-Michaels' business. Ralph had simply had lunch with Littlejohn, who said he would try to contact some "theoretical possibilities" to see if they had any interest in Hyman-Michaels.

As it turned out, Gold Fields, one of the "theoretical possibilities" mentioned at the January 24 lunch, had a subsidiary called Azcon Corporation ("Azcon") which, through yet another subsidiary, was doing business with Hyman-Michaels.

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[4] Because the decision to have the Company buy Joseph's stock was made on January 5, well before Ralph's luncheon with Littlejohn, and because Joseph, Ralph and Everett all had the same access to corporate information, this is not an "insider trading" case, nor have any such allegations ever been made.

When, *after* the Company bought Joseph's stock on January 27, 1976, Ralph first learned about the connection, he told Littlejohn that of his "theoretical possibilities" Gold Fields looked like the most likely candidate.

On Ralph's direction, and *after* the controlling January 27 date, Littlejohn began efforts to contact Azcon. Initially, Azcon had no interest, but after some major restructuring of the Company in which the less desirable parts of the Company's business were taken out of the deal, and many other hurdles were overcome, on July 8, 1976, Azcon purchased Hyman-Michaels' name and most of its metals business assets. Hyman-Michaels retained its unprofitable ocean shipping business, several million dollars in contingent liabilities and millions of dollars of debt. The net amount received by Ralph and Everett as of the time of trial was about $8.6 million, or $428 per share.[5]

REASONS FOR GRANTING THE WRIT

Summary

The Seventh Circuit held that petitioners' failure to disclose Ralph's lunch with Littlejohn was actionable under Rule 10b-5 because it represented "brightened prospects" or a "change in approach" regarding a sale of the Company, which, as a matter of law, could have been material to Joseph in connection with the sale of his stock. Contrary to recent holdings from other circuits based upon this Court's decision in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the Seventh Circuit has pushed back the threshold for disclosing soft premerger infor-

[5] Although the measure of damages is not the basis for this petition, it is significant, indeed ironic, to note that the jury awarded Joseph, the 14% *minority* shareholder, damages which, if the verdicts are upheld, will net him about $550 per share for his stock, whereas Ralph and Everett, the *majority* shareholders, will receive about $300 per share for theirs.

mation so far into the realm of speculation and uncertainty that matters required to be disclosed are "unknown and unknowable."[6] As a result, business people have no clear guidelines and liability looms if stock is bought or sold while anything which could possibly be characterized as "premerger activities" is occurring—a frequent state of affairs for many companies in these times of intensified merger activity. The problem is compounded by the fact that this new rule appears to apply only to "private" companies, a term left undefined by the Seventh Circuit.

Before the Seventh Circuit's ruling, courts of appeals consistently held with regard to both public and private companies that premerger activities need not be disclosed until there was at minimum a reasonable likelihood of a merger occurring (Second Circuit), more than a mere agreement in principle (Eighth Circuit), an agreement in principle regarding fundamental terms such as price and structure (Sixth Circuit), a firm or definite offer (Ninth Circuit), or, more strictly, that there was agreement on price and structure (Third Circuit). Although the standards announced in these five circuits are different as to when disclosure is made, the courts reason that before these points disclosure is likely to mislead, doing more harm than good. Professor Loss summed up the problem neatly concluding: "[*p*]*remature* disclosure of merger negotiations that are inherently fluid may be more misleading than secrecy." L. Loss, *Fundamentals of Securities Regulation,* 816 n.72 (1st ed. 1983 & 1984 Supp.) (emphasis in original). Under the Seventh Circuit's rule, however, federal courts are open to litigation by disgruntled sellers of stock who claim *ex post* that misstatements or omissions of trivial or irrelevant information were material to them in connection with their stock transactions. The Seventh Circuit's murky guidelines cannot coexist with this Court's recent holdings emphasizing the

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[6] *Landreth Timber Co. v. Landreth,* 471 U.S. ___, 105 S.Ct 2297, 2307 (1985)

importance of objective criteria for liability under the securities laws, nor with the business community's pressing need for reasonably clear rules of conduct. The Seventh Circuit's opinion is important, but it is wrong, and it has created further conflict among the circuits.

We are acutely aware of the risk of overstatement to this Court. But in these times of burgeoning merger activities in all sectors of our economy, one can safely conclude that the efficient working of free market forces affecting securities transactions will be enhanced if this Court resolves the ambiguities which now exist regarding premerger activities.

POINT I: THERE IS A CLEAR SPLIT OF AUTHORITY AMONG THE CIRCUITS REGARDING THE MATERIALITY OF PREMERGER ACTIVITIES

In order to establish a violation of Rule 10b-5, a plaintiff must prove, among other elements, that the defendant misstated a fact or omitted to state facts necessary to make a statement made not misleading. However, the misstatement or omission must be of a *material* fact. Since its seminal decision in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), this Court has not directly addressed the meaning of "material" in the context of a securities case. Prior to *TSC*, the circuits had split on the issue, some holding a fact is material if it "might" be important and others holding that a fact is material if it "would" be important. This Court, in a unanimous opinion, held in *TSC* that the higher objective standard, the "would have assumed substantial significance to the reasonable shareholder" test, was controlling.

The *TSC* decision is crucial to the analysis here. In explaining its holding, the Court said that the "disclosure policy embodied [in the federal securities laws] is not without limit" (426 U.S. at 448) and indicated that the *effects* must be considered whenever such a rule is formulated. The Court

recognized that a rule requiring disclosure of facts of "dubious significance" would do "more harm than good," especially where the facts were "too suggestive of mere possibility, however unlikely." *Id.* at 448-49. A rule which requires too much disclosure would, the Court noted, have an unwanted effect. In order to avoid liability, persons making disclosures would "bury the shareholders in an avalanche of trivial information." *Id.* at 448. A deluge of disclosure of facts of "dubious significance," would frustrate the basic goal of federal securities laws, which is "informed decisionmaking." *Id.* at 449.

In the years since *TSC*, the salutatory effects of the "would be important" test have become apparent. Before *TSC*, there were widespread fears of the potential for "limitless liability" under Rule 10b-5. *TSC* provided a clearer more objective standard for persons involved in disclosure decisions, and accordingly, the early fears of boundless liability have, in large part, abated.

However, in the area of premerger activities, and more particularly on the question of the point at which negotiations or other activities preceding mergers become material so that a person under a disclosure duty must make known these activities, *TSC*'s materiality test has proved troubling and has resulted in inconsistent and unpredictable decisions.[7] This case presents the opportunity to resolve this conflict among the circuits and provide guidance to the SEC.

The split in the circuits is clear. The Third Circuit does not consider premerger activities material until there is an agreement in principle specifying the *price* to be paid and the *structure* of the transaction. The Second Circuit employs a different test, and considers premerger activities legally immaterial until it is "reasonably likely" that there will be a merger

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[7] "Merger" is used to mean statutory mergers, acquisitions, sales of all or substantially all of a business' assets and similar fundamental transactions.

agreement. The Sixth Circuit requires disclosure "only after an agreement in principle regarding such fundamental terms as price and structure has been reached." The Eighth Circuit considers premerger activities material only when they have gone beyond a "mere agreement in principle." The Ninth Circuit finds there is no duty to disclose expressions of interest until they constitute "firm or definite offers."

The Seventh Circuit in the opinion below has formulated yet a sixth rule which is a radical departure from the different but more clearly defined approaches of the Second, Third, Sixth, Eighth and Ninth Circuits. Under the Seventh Circuit's test, guidelines of reasonable certainty or even probability are abandoned and premerger activities of *any* sort are material and must be disclosed whenever anything occurs which might be characterized as resulting in "brightened prospects" or as a "change in approach." Though not entirely clear, the Seventh Circuit opinion implies that some undefined but stricter test would apply to companies whose shares are "publicly traded."[8]

The leading premerger cases in the Third Circuit are *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3rd Cir. 1984), *cert. denied*, 105 S.Ct. 1189 (1985), and *Staffin v. Greenberg*, 672 F.2d 1196 (3rd Cir. 1982). In *Staffin*, the earlier case, the Third Circuit held that the duty to disclose premerger activities is not triggered until an agreement in principle exists or the parties have discussions which are "in some sense the functional equivalent of [an agreement in principle]." 627 F.2d at 1207. The later *Heublein* case expanded on the holding in *Staffin*,

[8] Should certiorari be granted, petitioners will urge that the Second Circuit's "reasonably likely" test be adopted. That test best effectuates the competing policies favoring both disclosure and reasonable guidelines. Moreover, it is the very test that Joseph initially relied on when the suit was brought and there apparently was some belief on his part that discovery would show Ralph and Everett knew a merger was "reasonably likely" when the Company bought Joseph's stock. Amended Complaint, ¶ 19(a).

stating that "an agreement in principle to merge ha[s] been reached when the parties [have an] agreement on 'price and structure.' " 742 F.2d at 757.

The Third Circuit's "price and structure" rule was derived from the effect-oriented approach of *TSC*. Thus, preliminary merger negotiations should not be disclosed due to the possibility that "the investing public would be misled as to likely corporate activity." *Heublein*, 742 F.2d at 757. If investors "buy stock based upon negotiations preceding a merger which never occurs", [investors would] be "left 'holding the bag' on a stock whose price was inflated by an inchoate hope". *Staffin*, 672 F.2d at 1207. The Third Circuit's approach comports with the opinion of Professor Loss and another leading commentator, who states that "merger negotiations become material when officers of both parties agree to an exchange ratio." 5A Jacobs, *Litigation and Practice Under Rule 10b-5*, § 61.04[c][ii] 3-244 (2d ed. 1985 Revision).

The Second Circuit does not follow the "bright line" approach embodied in the Third Circuit's "price and structure" rule. Rather, "each case must be approached on its own facts," *S.E.C. v. Geon Industries, Inc.*, 531 F.2d 39, 47 (2nd Cir. 1976), in terms of the "probability" of how likely it is at any particular point in time that a merger agreement will be reached. Although the opinions in the Second Circuit cannot be totally reconciled, the rule there seems to be that when events proceed to a point that a merger is "reasonably likely," then and only then does there arise a duty to disclose.

Reiss v. Pan American World Airways, Inc., 711 F.2d 11 (2d Cir. 1983), exemplifies the Second Circuit's approach. The court held that the negotiations there were *not* material and need not have been disclosed because there was no reasonable basis for predicting whether the negotiations would be successful.

> Such negotiations are inherently fluid and the outcome shrouded in uncertainty . . . we are not confronted

> here with a failure to disclose hard facts which definitely affect a company's financial prospects, rather we deal with complex bargaining between two (and often more) parties which may fail as well as succeed, or may succeed on terms which vary greatly from those under consideration at the suggested time of disclosure.

711 F.2d. at 14.

The *Reiss* decision was based upon the same realization motivating the Third Circuit's decisions—that the fluidity and uncertainty of preliminary negotiations is such that "disclosure may, in fact, [have been] more misleading than secrecy as far as investment decisions are concerned." 711 F.2d at 14. This concern is very similar to this Court's conclusion in *TSC* that the disclosure of facts of "dubious significance" does more harm than good. Indeed, as the court noted in *Reiss*, the significance and meaning of events occurring before it is reasonably likely that a merger agreement will be reached are so elusive, so unsusceptible of definition and articulation, that "had [Pan Am] disclosed the existence of negotiations . . . and had those negotiations failed, we would have been asked to decide a Section 10b-5 action challenging that disclosure." *Id.*

The Sixth Circuit, which addressed this issue most recently, concluded disclosure of premerger discussions is warranted "only after an agreement in principle, regarding such fundamental terms as price and structure, has been reached." *Starkman v. Marathon Oil Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,290, at 91,988 (6th Cir., September 13, 1985). The *Starkman* court stressed that "disclosure of preliminary discussions could very easily mislead shareholders as to the prospects of success." *Id.*

The Eighth Circuit requires disclosure only when the merger activities have "advanced beyond the stage of a tentative agreement. Parties are not required to disclose plans which are contingent or indefinite." *Missouri Portland Cement Company v. H. K. Porter Company, Inc.*, 535 F.2d 388, 398 (8th Cir. 1976).

The Ninth Circuit has formulated yet another test. It concludes that no duty to disclose exists where "inquiries or indications of interest . . . do not fall within the category of firm or definite offers." *South Coast Services Corp. v. Santa Ana Valley Irrig. Co.*, 669 F.2d 1265, 1273 (9th Cir. 1982).

The important point is that the Second, Third, Sixth, Eighth and Ninth Circuits all agree on the necessity of drawing an identifiable line at the point at which premerger activities become material, although they differ slightly as to where that line should be. By contrast, the Seventh Circuit in this case has simply erased the line altogether. The Seventh Circuit believes that what triggers the duty to disclose is *not* the occurrence of an event which indicates that there is a some degree of certainty, or even a *reasonable likelihood*, that a merger agreement will be entered into. Instead, the duty to disclose is triggered by standards truly unknown and unknowable: a "change in approach" or "brightened prospects." (Slip at 15; App. 17a) Since nearly *any* event—hiring a business broker or firing a broker, talking to one broker instead of another, commencing negotiations or adjourning negotiations, or whatever—will necessarily involve a "change in approach" or in some way "brighten" or "dim" prospects, the Seventh Circuit's tests have no rational boundaries, and *every* event could be material and require disclosure no matter how trivial or insignificant it may be in practical terms.

The key to the Seventh Circuit's analysis and the reason its result is wrong may be traced directly to its assumption that the meaning and significance of premerger activities *can* be accurately determined and articulated. The Seventh Circuit said:

> There was also no danger that disclosure would mislead Joseph. If Joseph had a question about what Littlejohn . . . said, he could simply ask Ralph and Everett and they could clarify any possibly misleading statement.

(Slip at 11; App. 13a) However, the underlying assumption is unfounded. As the court noted in *Reiss*, premerger activities

are "inherently fluid" and "shrouded in uncertainty". Any attempt to make disclosure "may be . . . misleading . . . so far as investment decisions are concerned." *Reiss*, 711 F.2d at 14.

The Seventh Circuit seeks to justify its result by dividing the business world into two subsets, public and private companies, and then attempting to limit its new rule to companies where "there is no public market for a shareholder's stock", (Slip at 11; App. 13a.) However, the effort is doomed. Although the Seventh Circuit purports to limit its holding to private companies, the logic of the decision indicates that the rule is equally applicable to public companies. If premerger activities can be accurately described, assessed and articulated, it is not because the activities relate to a private rather than a public company. Management of a public company is just as able to accurately disclose such activities as the management of a private company. Moreover, just as shareholders of a *private* company can ask for and obtain clarifications, so too can securities analysts, investment brokers and stockbrokers—as well as shareholders—ask for and obtain clarifications about a public company.[9]

The public/private distinction is virtually impossible to apply. The Seventh Circuit offers no guidelines as to what is a public and what is a private company. Three shareholders? Sixteen? A company with one hundred shareholders where the treasurer makes a sporadic auction market? A NASDAQ shell company whose shares rarely trade? A company which is public with respect to its preferred stock, but private with respect to its

[9] In addition to the cases we have already cited, appellate decisions from the Seventh and other circuits have refused to apply a so-called public/private dichotomy in holding premerger nondisclosures immaterial as a matter of law in the context of privately held companies. *E.g. Hassig v. Pearson*, 565 F.2d 644 (10th Cir. 1977); *James Blackstone Memorial Library Assoc. v. Gulf, Mobile and Ohio R.R. Co.*, 264 F.2d 445 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959)

common, or vice versa? The commentators have despaired of finding any meaningful way of telling when a corporation ceases to be closely held and have talked of "the twilight zone when a close corporation mysteriously transmutes itself into a non-close (if not yet wholly public) enterprise."[10]

One leading commentator described the problems which arise in trying to determine whether shares are publicly traded:

> Several [state] statutes make certain provisions applicable only to corporations no shares of which . . . are "regularly quoted" or "generally traded" . . . Such language no doubt aptly describes the close corporation and, indeed, probably best describes it. However, inherent in this description, which purports to be a definition, is a disturbing uncertainty in its application to practical problems and in some of its implications. Several rhetorical questions suggest some of the difficulties. When do shares become "regularly quoted" or "generally traded"? Assuming arguendo that recurrent appearances in the "pink sheets" can be equated with "regular quotations," no such event signals the beginning of "general trading" in the shares.

Folk, *Corporation Statutes: 1959-1966*, 1966 Duke L.J. 875, 947.

There are, no doubt, thousands, probably tens of thousands, of corporations whose securities are so lightly or so infrequently traded that a real question would exist as to whether the shares are publicly traded. As a result, persons who have transactions in securities of these twilight zone companies will be unable to determine whether the special duties imposed by the Seventh Circuit on persons dealing in securities which are not publicly traded are applicable.

In sum, a review of the Second, Third, Sixth, Seventh, Eighth and Ninth Circuits indicates that all six have tried to follow *TSC*. But each has reached a different result. Since all of the circuits have followed the appropriate methodology, but

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[10] Folk, *Corporation Statutes: 1959-1966*, 1966 Duke L.J. 875, 947.

reached different results, there is little room for further doctrinal development and no real chance for reconciliation of their positions. Accordingly, this conflict is ripe for this Court's review.

POINT II. THE SEVENTH CIRCUIT'S OPINION IS DIAMETRICALLY OPPOSED TO GUIDING PRINCIPLES OF SECURITIES REGULATION LAID DOWN BY THIS COURT OVER THE PAST DECADE

Beginning with *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975), this Court has decided a series of cases establishing clearly defined objective rules to (1) take the guesswork out of decisions which business persons make when they engage in securities transactions, (2) enable the free market for securities transactions to function effectively in the context of these rules and (3) protect the federal courts from inundation with litigation not properly brought under the federal securities laws. In *Blue Chip,* the Court held that a Rule 10b-5 plaintiff must be an actual purchaser or seller of stock, not merely someone who claimed he or she would have been a purchaser or seller but for some accused conduct. The Court reasoned that without such a rule, 10b-5 actions would turn largely on whose testimony the jury decides to credit, and courts would find it virtually impossible to dispose of Rule 10b-5 cases prior to trial, regardless of how improbable the plaintiff's claims. The Court observed:

> The very real risk in permitting those [who are neither purchasers nor sellers] to sue under Rule 10b-5 is that the *door will be open to recovery of substantial damages on the part of one who offers only his own testimony* to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him.
>
> The virtue of the [purchaser-seller] rule . . . is that it limits the class of plaintiffs to those who have at least dealt in the security . . . And their dealing in the security . . .will gener-

> ally be an *objectively demonstrable fact in an area of law otherwise very much dependent upon oral testimony.*

(Emphasis added) 421 U.S. at 746-47.

Following *Blue Chip,* the Court underscored the need for objective guidelines for securities claims by adopting a strict "intent to deceive" scienter approach in *Ernst & Ernst v. Hochfelder* 425 U.S. 185 (1976), and then continued this theme in *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462 (1977), by refusing to allow widely-varying state-law waste and mismanagement claims to be bundled under the rubric of federal securities fraud.

The need for clear workable *ex ante* tests was emphasized again last term by the Court's decisions in *Landreth Timber Company v. Ivan K. Landreth,* 471 U.S. ___, 105 S. Ct. 2297 (1985), and *Gould v. Ruefenacht,* 471 U.S. ___, 105 S. Ct. 2308 (1985). In rejecting the "sale of business" doctrine in *Landreth,* the Court observed that applying it where less than 100% of a company's stock was sold "inevitably would lead to difficult questions of line drawing." 105 S.Ct. at 2307. And, more pertinent to the need for clarity and predictability, the Court stated that the "sale of business" rule was undesirable because, under it:

> ... coverage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold. These uncertainties attending the applicability of the Acts would hardly be in the best interests of either party to a transaction. ... We find more daunting, however, the prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation over a concept as often elusive as the passage of control.

Id. If passage of control is an "elusive" concept then *a fortiori,* struggling with the Seventh Circuit's new tests of "brightened prospects" or "change in approach" is a far more daunting task.

The Seventh Circuit's decision that preliminary premerger conduct is material under *TSC,* but only for non-public companies, when there is evidence of "brightened prospects" or "change in approach," creates an intractable rule which cannot co-exist with either *TSC's* objective standard of materiality or *Blue Chip's* focus on "objectively demonstrable facts." In the practical world of business transactions, premerger conduct must reach a certain stage of reasonable probability before it becomes objectively material and requires disclosure. To find that mere intentions, preliminary musings, or in the words of *TSC,* other matters of "dubious significance", must be disclosed would undermine cohesive enforcement of the securities laws as well as this Court's recent decisions. Without reasonably clear guidelines indicating when premerger conduct becomes material, business persons can never know when to disclose and when not to.

Finally, it is now widely recognized that efficient corporate functioning depends on minimizing transaction and agency costs. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 Harv. L. Rev. 1161, 1170 (1981). However, these costs will soar if the Seventh Circuit's opinion remains the law. There are thousands of corporations large and small whose stock is not publicly traded. Under the Seventh Circuit's opinion, management of these companies will now have to consult lawyers whenever their stock is bought or sold when there is anything resembling premerger activity on the horizon. Lawyers, without clear guidelines and risk averse, will advise disclosure of any premerger conduct that could possibly be construed as a "brightened prospect" or "change in approach" to all shareholders before entering into any securities transactions. This will include requiring disclosure of a casual approach by a broker on the golf course or at a cocktail party, or, as in the case at bar, at a social lunch, any of which could be later construed as a "brightened prospect". It will also include an internal decision to try to do an asset sale instead of a statutory merger or to

change from one business broker or investment banker to another, any of which could be later construed as a "change in approach" under the Seventh Circuit's test. "From now on, the corporate spokesman 'will have to sit next to the chairman' and be part of the negotiating group". Hertzberg & Leefeldt, *SEC's Merger-Disclosure Ruling May Add to Stock-Price Volatility,* Wall St. J., July 10, 1985, at 27. Under the murky Seventh Circuit guidelines, every seller of stock will be able to get to a jury merely by claiming that had he known management was considering the possibility of a sale or merger, or hiring a broker, or changing its approach, he would not have sold, no matter how speculative and remote management's conduct was at the time of the sale. Without clear guidelines the risk of juries returning capricious verdicts based upon selective recall, subjective factors or lawyers' histrionics is substantially increased. The case at bar is a case in point.

POINT III: THE SEVENTH CIRCUIT'S DECISION IMPLICATES IMPORTANT PUBLIC POLICY CONSIDERATIONS

This case involves not only a conflict among the circuits and an approach that is opposed to recent pronouncements of this Court, but important considerations of public policy as well. The SEC found the issues in this case to be significant. When the Seventh Circuit issued its original opinion on July 3, 1985, it accepted the "price and structure" rule of *Greenfield* and *Staffin,* noting that "Ralph and Edward [sic] would have had no duty to disclose the meeting with Littlejohn . . . if Hyman-Michaels' stock were publicly traded" but sought to distinguish this case on the grounds that it involved a "private" company (Original Slip at 10-11; App. 42a-43a). When petitioners sought rehearing, the SEC filed an amicus brief attacking the public/private dichotomy as "unfair" and urged the Seventh Circuit to retreat from that unwieldy distinction (App. 95a). The Seventh Circuit refused to abandon the

approach, but did accommodate the SEC to the extent that its amended opinion avoided expressly approving the Third Circuit's price and structure rule.

The SEC's amicus brief in this case coincided with its publication of a major report on a private investigation concerning merger negotiations regarding Carnation Co. and Nestle, S.A. *In the Matter of Carnation Company,* Sec. Act Rel. No. 22214 (July 8, 1985) *reprinted in* (1984-1985 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 83,801. There, the SEC espoused an approach to materiality of premerger activities which is strikingly similar to the Seventh Circuit's holding. At issue was whether merger negotiations between Carnation and Nestle were material. The SEC found that they were because there had been three meetings between the companies, an acquisition price was proposed and rejected, Carnation had asked its investment banker for a fairness opinion and Nestle indicated that *if* an offer were made it *might* occur as early as three days hence. In its release, the SEC did not suggest any tests for determining when negotiations become material, simply concluding that these facts were material. There was nothing in the release to suggest that the *probability* of a merger was a relevant consideration nor did it provide any discernable guidelines as to when negotiations become material.

Recognizing that the SEC's release represented a radical departure from established precedent, public reaction was swift, strong and widespread.[11] Most of the news articles not only reported the SEC release but critically analyzed it. The Wall

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[11] News of the SEC's release was reported in the Wall Street Journal, Hertzberg & Leefeldt, *SEC's Merger—Disclosure Ruling May Add to Stock-Price Volatility,* Wall St. J., July 10, 1985, at 27, the New York Times, *S.E.C. Report on Carnation,* N.Y. Times, July 9, 1985, D, at 21, the Washington Post, Ross, *SEC Warns on Disclosure Rules; To Act Against Misleading Information About Merger Plans,* Wash. Post, July 9, 1985, § E at 3, Forbes, Lunzer, *No Comment,* Forbes, Sept. 16, 1985, at 41, Fortune, Rogers, *Merger Talk,* Fortune, August 4, 1985, at 8, Business Week, *The SEC: Don't Mislead in Mergers,* Bus. Wk., July 22, 1985, at 74, and in an AP wire story.

Street Journal quoted a former SEC General Counsel who called the release a "major pronouncement" which was "troubling and impractical." Hertzberg & Leefeldt, *SEC's Merger-Disclosure Ruling May Add to Stock Price Volatility,* Wall St. J., July 10, 1985, at 27.[12] Fortune quoted Martin Davis, chairman of Gulf & Western, as stating: "There is a larger issue here: What is the SEC doing to protect the investor? This won't cure anything. It's infecting the wound." Rogers, *Merger Talk,* Fortune, August 5, 1985 at 8. The Forbes story stated that:

> No one in corporate communications can think of a way to avoid [ending up in court over premerger disclosure issues] "Our clients are scared to death" says Robert Taft, Senior Vice president of Hill & Knowlton's Financial Relations Division.

Lunzer, *No Comment,* Forbes, September 16, 1985 at 41.

POINT IV: THE SEVENTH CIRCUIT'S DECISION IS SO FAR A DEPARTURE FROM ACCEPTED JUDICIAL PROCEEDINGS AS TO JUSTIFY SUPREME COURT REVIEW

Most of the energy of the parties and the courts below has focused on the premerger issues which lie at the heart of this case. However, the decision below is also infected with another error which underscores the problems of premature disclosure of soft information and is highly significant to Ralph and Everett, the majority shareholders of 86% of Hyman-Michaels'

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[12] The Wall Street Journal stated:

> But as well as providing more information to the public, the SEC's efforts also may have a dark side for the small investor. That's because it could mean more speculative trading on merger talks while they still are in their earliest stages . . . or even when they don't exist. And this would add to the volatility of stock prices, as well as lure the small investor into the game of guessing on which merger deals will be completed.

Id.

stock who, if this decision is affirmed, stand to net less for their stock than Joseph, the minority shareholder. It concerns the "bank said 'no' " incident.

The Seventh Circuit's finding that Ralph's statement regarding the negotiations with the Bank was somehow material or relevant to Joseph's decision to sell his stock is wholly without support from this record. Despite his own self-serving testimony to the contrary (Trial Tr. 292), throughout these proceedings Joseph never advanced a credible theory of how Ralph's statement mattered or how he relied on it. To do so would, in fact, be a logical impossibility, since the Bank negotiations terminated conclusively several weeks *before* Joseph sold his stock and in no way affected (1) Joseph's decision to sell (which was motivated by personal reasons having to do with ill will among certain family members), (2) the price at which he sold (which never varied from the $300 he asked for) nor (3) the timing of the sale (which was determined by Ralph and Everett for reasons having nothing to do with the Bank).

Joseph's initial theory was that Ralph's statement was understood by Joseph as conveying some information about the stock's value. That theory, however, was discredited when at trial Joseph admitted that Ralph's statement was not so understood by him. (Trial Tr. 263)

The Seventh Circuit speculated that Ralph's statement may have been relevant because Joseph supposedly decided as a result to "forego his request that his stock be bought with Everett's and instead to sell only his stock to the Company" (Slip at 18; App. 20a). Such a conclusion reflects a profound misunderstanding of the record. Joseph never advanced such a theory nor does the record support it. Similarly irrelevant is the Seventh Circuit's conclusion that the "misstatement" was relied on by Joseph because it caused him to seek financing for his own ill-fated run at the Company. (Slip at 18; App. 20a).

Even if that is so, such efforts had no possible relevance to Joseph's stock sale. The record clearly shows that Joseph took no action nor forebore from any as a result of Ralph's statement about the Bank negotiations and accordingly the required element of 10b-5 reliance is absent. W. Prosser, *Torts*, § 108 at p. 714 (4th ed. 1971).

In the final analysis, far from providing an independent basis for upholding the Seventh Circuit's judgment, as Joseph may assert, the whole "bank said 'no' " incident points up the danger of requiring premature disclosure of soft, negotiation-related information. When Ralph disclosed the status of the Bank negotiations and, because of its newfound skepticism regarding the proposed increase in the loan he told Joseph that the bank said "no," he gave the most accurate portrayal of the loan negotiations that he could. In fact, however, as Joseph reveled in pointing out, the loan had not completely fallen through. Joseph's demand to be bought out for an additional $1 million had simply caused the Bank to require Ralph's personal guarantee, which, as Joseph knew, Ralph would not give. Thus, while in Ralph's mind, the bank *had* said no, Joseph and perhaps the jury, looking at the exact same facts, concluded *ex post* that the Bank had not said "no," but something less discouraging. This vignette illustrates the mischief inherent in requiring premature disclosure of any negotiations and how such disclosure of information of dubious significance tends to mislead. It shows the dilemma for the wide range of persons under disclosure obligations that is created by the Seventh Circuit's opinion. They are, as Ralph's predicament illustrates, damned if they do disclose—as Ralph did with regard to the Bank negotiations—and damned if they do not—as Ralph did not with regard to his luncheon discussion in London with his old friend Angus Littlejohn.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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APPENDIX

United States Court of Appeals

FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

September 17, 1985

Before

HON. HARLINGTON WOOD, JR., Circuit Judge
HON. JOEL M. FLAUM, Circuit Judge
HON. WESLEY E. BROWN, Senior District Judge*

JOSEPH MICHAELS,

Plaintiff-Counterdefendant-Appellee,

Nos. 84-1631, 84-1714

vs.

RALPH MICHAELS, EVERETT B. MICHAELS, and HYMAN-MICHAELS COMPANY,

Defendants-Counterplaintiffs, Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 78 C 3274

Stanley J. Roszkowski, *Judge*

ORDER

IT IS ORDERED, sua sponte, that the following corrections are made in the slip opinion in the above-entitled case decided July 3, 1985, and amended September 9, 1985:

The single asterick footnote on page one of the opinion should be deleted and the following footnote substituted in its place:

"*In light of this amended opinion, the petition for rehearing and suggestion for rehearing in banc filed on

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* The Honorable Wesley E. Brown, Senior District Judge for the District of Kansas, is sitting by designation.

July 17, 1985, by defendants/counterplaintiffs/appellants, is denied since no judge in active service has requested a vote thereon, and all the judges on the original panel have voted to deny a rehearing. We acknowledge the assistance of the SEC in filing an amicus brief in connection with the petition for rehearing."

Page 2, line 14: delete "10b-5 and."

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 84-1631, 84-1714

JOSEPH MICHAELS,

Plaintiff-Counterdefendant-Appellee,

v.

RALPH MICHAELS, EVERETT B. MICHAELS and HYMAN-MICHAELS COMPANY,

Defendants-Counterplaintiffs-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 78 C 3274—Stanley J. Roszkowski, *Judge.*

ARGUED FEBRUARY 21, 1985—DECIDED JULY 3, 1985
AMENDED SEPTEMBER 9, 1985*

Before WOOD and FLAUM, *Circuit Judges*, and BROWN, *Senior District Judge.***

WOOD, *Circuit Judge.* This case involves a family squabble between the plaintiff Joseph Michaels and his uncles, defendants Ralph Michaels and Everett Michaels.[1] Joseph claims that when he sold his stock in the family business, the Hyman-Michaels Company ("the Com-

* In light of this amended opinion, the petition for rehearing is denied. We acknowledge the assistance of the SEC in filing an amicus brief in connection with the petition for rehearing.

** The Honorable Wesley E. Brown, Senior District Judge for the District of Kansas, is sitting by designation.

[1] To avoid confusion about which of the Michaels we are referring to, we will refer to them by their first names.

pany"), to the Company in January of 1976, his uncles misstated and withheld material information that, if revealed, would have affected his decision to sell. Joseph subsequently brought this action, alleging that his uncles and the Company had violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and had committed common-law fraud. Joseph's complaint also charged his uncles with a breach of a fiduciary duty and the Company with a breach of the warranty provision of the contract for the sale of stock. The parties tried the case before a jury in November, 1983, and the jury found for Joseph and against his uncles on the 10b-5, fiduciary duty, and common-law fraud claims, but against Joseph and for the Company on the 10b-5 and warranty claims. The jury assessed damages at $750,000 and also awarded Joseph $200,000 in punitive damages on the common-law fraud claim. The district court subsequently denied defendants' motion for judgment notwithstanding the verdict or a new trial, awarded Joseph prejudgment interest, and directed a verdict for Joseph on the Company's counterclaim.

This appeal raises a number of issues. The defendants argue that they did not violate section 10(b) or Rule 10b-5 because (1) the withheld information was immaterial as a matter of law, (2) they did not possess the requisite scienter, and (3) the plaintiff did not rely on any misstatement and would have sold his stock even if he had known the withheld information. The defendants also challenge several of the district court's evidentiary rulings, its denial of their motion for a new trial, and the directed verdict for the plaintiff on the Company's counterclaim. We affirm.

I.

The Hyman-Michaels Company was in the business of purchasing, processing, and distributing scrap iron and steel. In mid-1975, Everett owned or controlled approximately fifty percent of the outstanding voting common

stock of Hyman-Michaels, Ralph owned or controlled approximately thirty-six percent, and Joseph owned fourteen percent. On January 27, 1976, Joseph agreed to sell his shares to the Hyman-Michaels Company for $300 a share. Three days later, Joseph delivered the stock, resigned from his offices in the Company, and received $981,276.73. In July, 1976, Everett and Ralph sold the assets of the Company for approximately $13.4 million plus lifetime employment contracts. Joseph claims that Everett and Ralph withheld three material facts from him: (1) that the Continental Illinois National Bank ("Continental Bank") had not said "no" to the Company's loan request; (2) that Everett and Ralph decided to retain a professional financial firm to obtain a purchaser for Hyman-Michaels's assets; and (3) that Ralph had met with Angus Littlejohn in London and that Littlejohn had agreed to contact some prospective purchasers.

A.

Between 1966 and 1976, Hyman-Michaels negotiated with approximately ten different companies in unsuccessful attempts to sell either the Company's assets or the stock owned or controlled by Ralph, Everett, and Joseph. In mid-summer 1975, Ralph began discussions with the Commercial Metals Company ("Commercial Metals") designed to effect a sale of the assets of Hyman-Michaels. The two parties discussed prices, based on asset value, of approximately $14 million. On September 5, 1975, while the Commercial Metals negotiations were ongoing, Ralph, Joseph, and Al Moeng (a Hyman-Michaels financial officer) met with Angus Littlejohn, a consultant to International Carbon & Minerals Corporation ("ICM"), and John Samuels, the chairman of ICM, to discuss the possibility of ICM acquiring Hyman-Michaels. A purchase price in the range of $12 to $14 million was mentioned, but Ralph terminated the meeting without further pursuing Samuels's proposal because Ralph felt that the ongoing discussions with another company (Commercial Metals)

precluded such a dialogue. Ralph told Littlejohn and Samuels that he would contact them if negotiations with the other company fell through.

The Commercial Metals negotiations ended in December, 1975. Worried about Everett's health and the possible problems for Hyman-Michaels if Everett would die and his shares go into probate, Ralph suggested that the Company borrow money and buy back Everett's common stock for $300 per share. This price was less than the stock's book value, but Everett agreed to accept $300 because Ralph said that was all the Company could afford. Ralph and Al Moeng consequently contacted Bruce Simons, a loan officer at the Continental Bank, about borrowing the approximately three million dollars needed to buy out Everett. Ralph also advised Joseph that all three shareholders would need to sign a "unanimous stockholders consent" before the Company could borrow money for Everett's shares.

While the Company was negotiating with the Continental Bank for a loan, Ralph told Joseph that, after Everett's stock was purchased, Ralph would own or control about seventy-five percent of Hyman-Michaels's voting stock with Joseph owning approximately twenty-five percent of that stock. Ralph also said that he intended to place his wife and his son-in-law on Hyman-Michaels's Board of Directors when Everett left the Company. Joseph consequently became concerned about what would happen to his family if he or Ralph died, given Ralph's wife's apparent ill-will toward Joseph's wife. Joseph therefore sought advice from Harrison Fuerst, a friend who practiced law in Cleveland, Ohio. Fuerst suggested that Joseph ask Ralph to accept one of three proposals: (1) that Hyman-Michaels offer Joseph a buy-sell agreement for his stock; (2) that Ralph and Joseph place their stock in a voting trust so that each would have equal votes; or (3) as a last and least desirable alternative, that Hyman-Michaels purchase Joseph's stock at the same time and for the same price that it purchased Everett's stock.

Joseph and Fuerst presented these proposals to Ralph, Moeng, and Marvin Chapman, the Company's lawyer, on January 4, 1976. Either Ralph or Chapman rejected the first two proposals, but Ralph agreed to ask the Continental Bank for an additional one million dollars to buy Joseph's shares along with Everett's. Ralph said, however, that he thought Joseph's request would "kill the deal" and that, as far as Ralph was concerned, Joseph was "out" of Hyman-Michaels no matter what Continental said. After this meeting, Ralph and Chapman went to Everett's house to report what had happened; Everett agreed that the Company should buy out Joseph. When Chapman related Joseph's desire not to be kicked out of the Company and lose his job, Everett responded, "I don't give a damn."

On January 5, 1976, Ralph and Moeng went to Continental Bank and requested the additional financing to buy Joseph's stock. Later that day, Simons told Ralph that the bank would not loan Hyman-Michaels either the three million dollars originally requested or the four million dollars unless the loan were secured with Ralph's personal guarantee. Moments later, Joseph was summoned to Moeng's office, where Ralph told him, "Joe, you're out. The bank has said no." Ralph reiterated that Joseph was relieved of all duties at Hyman-Michaels.

B.

Joseph also claims that Ralph and Everett never told him that they had decided to retain a professional financial firm to locate a purchaser for the Company. On January 5, 1976, Charles Aaron met briefly with James Hemphill and James Gorter of the investment firm of Goldman, Sachs & Co. ("Goldman, Sachs"). Aaron told Gorter only that he represented a company that might be interested in seeking a buyer. On January 24, 1976, Ralph told Littlejohn that Hyman-Michaels was considering retaining Goldman, Sachs. As it turned out, the Company never retained Goldman, Sachs or any other investment firm.

C.

The third alleged misrepresentation concerns Ralph's contact with Angus Littlejohn in London on the 23rd and 24th of January. Prior to his departure for Europe, Ralph told Joseph that he (Ralph) would try to reactivate interest in a purchase of Hyman-Michaels and promised to report any such interest to Joseph. On January 23, 1976, while in London, Ralph telephoned Angus Littlejohn and told him that Hyman-Michaels was no longer negotiating with Commercial Metals. Ralph asked Littlejohn if ICM and John Samuels were still interested in buying Hyman-Michaels. At Littlejohn's request, Ralph agreed to stay in London an extra day and meet Littlejohn for lunch.

After his telephone conversation with Ralph, Littlejohn sent the following telex to John Samuels in New York:

> RALPH MICHAELS OF HYMAN MICHAELS COMPANY CHICAGO, WHOM I AM SEEING TOMORROW, JUST TOLD ME THAT THE PROPOSED SALE OF THEIR COMPANY COLLAPSD [sic] RECENTLY AT THE VERY LAST MINUTE.
>
> I PRESUME THAT WE [ICM] WOULD NOT BE INTERESTED AT THIS STAGE BUT WOULD APPRECIATE YOUR OPINION AS TO WHETHER IT MIGHT APPEAL TO DAVID.
>
> IF THIS IS TO BE PURSUED PLEASE GIVE ME TIME TO FIRST ESTABLISH A POSITION AS BROKER WITH RALPH.

"David" referred to David Lloyd-Jacob, the executive director of Consolidated Gold Fields in North America ("Consolidated") and the president of Azcon Corporation ("Azcon"), who had toured Hyman-Michaels's Hegewisch yard with Ralph in 1974. By telex dated January 24, 1976,

but not received by Littlejohn until January 26, 1976, Samuels responded, stating that Lloyd-Jacob "would definitely be interested" but that Samuels first wanted the chance for ICM to buy Hyman-Michaels.

On January 24, 1976, Ralph had lunch with Littlejohn. Ralph repeated what he had told Littlejohn the day before and identified Goldman, Sachs as the investment banker Hyman-Michaels intended to retain. Littlejohn mentioned a number of companies that he thought might be interested in acquiring Hyman-Michaels, including Consolidated. Littlejohn then asked Ralph to exclude those companies—including Consolidated—from any agreement Ralph might reach with Goldman, Sachs so that Littlejohn could obtain a brokerage fee if he were able to effect the purchase of Hyman-Michaels by one of those companies. Ralph told Littlejohn: "Get your ducks lined up."

On January 26, 1976, Ralph had a luncheon meeting with Everett and Hyman-Michaels's lawyers, Aaron and Chapman. Ralph told the others about his meeting with Littlejohn and described the companies, including Consolidated, that Littlejohn had indicated were potential purchasers of Hyman-Michaels. Joseph—still a stockholder, officer, and director of Hyman-Michaels—was not invited. Ralph told those gathered that Littlejohn was going to contact certain companies, including Consolidated, on behalf of Hyman-Michaels. The next day, still without telling Joseph of Ralph's conversations with Littlejohn, Ralph and Everett signed the agreement to buy Joseph's stock. In July, 1976, Ralph and Everett sold the Company's name and assets to Azcon for $13.4 million and lifetime employment contracts.

II.

Section 10(b) and Rule 10b-5 make it unlawful to misrepresent or fail to disclose material information in connection with the purchase or sale of securities. *See* 15

U.S.C. § 78j(b) (1982); 17 C.F.R. 240.10b-5 (1984); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 150-54 (1972). The defendants argue that the jury verdict on the section 10(b) and Rule 10b-5 claim must be overturned because the information withheld from Joseph was immaterial as a matter of law, because there was no evidence of scienter, and because Joseph did not rely on Ralph's alleged misstatement about the bank. The standard for determining whether the district court should have granted a judgment notwithstanding the verdict ("j.n.o.v.") is "whether the evidence presented, combined with all reasonable inferences permissibly drawn therefrom, is insufficient to support the verdict when viewed in the light most favorable to the party against whom the motion is directed." *Syvock v. Milwaukee Boiler Manufacturing Co.*, 665 F.2d 149, 153 (7th Cir. 1981).

A.

For purposes of section 10(b) and Rule 10b-5, an omission or misstatement is material if there is a "substantial likelihood that, under all the circumstances, the omitted [or misstated] fact would have assumed actual significance in the deliberations of the reasonable shareholder." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The materiality of the information misstated or withheld is determined in light of what the defendants knew at the time the plaintiff committed himself to sell the stock, in this case by signing the agreement to sell on January 27, 1976. *See Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 891 (2d Cir. 1972) (commitment to sell occurs when "the parties obligated themselves to perform what they agreed to perform even if the formal performance of their agreement is to be after a lapse of time"); *see also Goodman v. Epstein*, 582 F.2d 388, 411-12 (7th Cir. 1978) (quoting *Radiation Dynamics* with approval but distinguishing it on the facts), *cert. denied*, 440 U.S. 939 (1979). Thus activities occurring after

January 27, 1976 are relevant to the materiality issue only to the extent that they reflect what Ralph or Everett knew at the time they signed the stock purchase agreement.[2]

The defendants-appellants argue that under this objective test of materiality the discussions with Goldman, Sachs and Angus Littlejohn were immaterial as a matter of law. They base their argument on several cases that held that preliminary merger negotiations are immaterial as a matter of law. For example, in *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985), the Third Circuit held that merger negotiations do not become material until the merging companies agree on both price and the post-merger structure. *See also Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983). We note, however, that a number of cases do not apply a "bright line" rule of

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[2] The appellants also assign as error the district court's refusal to give their proposed instructions 9 and 10. Proposed instruction 9 stated, in part, that the jury "should not . . . determine the materiality of any omitted fact based on matters occurring after 1-27-76." Instruction 10 stated, in part, "Unless defendants had knowledge of material inside information on or prior to the commitment date, they were under no duty to the plaintiff to make any disclosure to the plaintiff or to abstain from buying the plaintiff's stock." We believe the trial court properly refused to give defendants' instruction 9 because, as we hold above, matters happening after January 27, 1976 were relevant to the extent that they reflect what defendants knew on January 27. As for instruction 10, we think the jury received the equivalent instruction from the trial judge when he told the jury:

> In order for the defendants' alleged misstatements and omissions to have been material within the meaning of the securities laws, they must have occurred in connection with the sale of his Hyman-Michaels stock. Thus, in order to satisfy the 'in connection with' requirement, the misstatements and omissions must have been known to the purchaser and must have occurred on or prior to Joseph's executing the contract on January 27, 1976.

See Beard v. Mitchell, 604 F.2d 485, 497-98 (7th Cir. 1979) (no error if requested instruction is given "in substance").

materiality for merger negotiations. *See SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)(balancing the probability that an event will occur and the magnitude of the event); *SEC v. Shapiro*, 494 F.2d 1301, 1305-07 (2d Cir. 1974)(balancing approach); *see also Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 131-34 (S.D.N.Y. 1984); *SEC v. Gaspar*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985)(mere existence of merger negotiations is material when company founder had never previously considered selling his shares); *In re Carnation Co.*, Exch. Act. Rel. No. 22214 (July 8, 1985), *reprinted in* [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595-97 (public denial of takeover rumors was material even though parties had had only one meeting and several telephone conversations).

We need not decide whether to adopt the Third Circuit's "price and structure" standard of materiality because the policy underlying that standard is not applicable on the facts of this case. The Third Circuit based the *Greenfield* holding on the theory that disclosing preliminary merger negotiations would cause speculative investment in the target company's stock, thus raising the price. If the merger negotiations subsequently fail—as they frequently do—the price of the target company's stock falls; investors who bought shares at inflated, post-disclosure prices suffer a loss and shareholders who would have otherwise sold may find that they can no longer obtain even the pre-disclosure price. *See Greenfield v. Heublein, Inc.*, 575 F. Supp. 1325, 1336 (E.D. Pa. 1983), *aff'd*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985). Therefore, to avoid any misleading caused by disclosing that a company is discussing merger possibilities, both the Third Circuit and a panel of the Second Circuit have held that the existence of preliminary merger negotiations is immaterial as a matter of law. *See Reiss*, 711 F.2d at 14; *Staffin v. Greenberg*, 672 F.2d 1196, 1205-07 (3d Cir. 1982). The need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations, the courts reason, outweighs the right of

shareholders to have notice of corporate developments important to their investment decisions. *Greenfield*, 742 F.2d at 756. As the Second Circuit noted, "[w]e have no doubt that had [the company] disclosed the existence of negotiations . . . and had those negotiations failed, we would have been asked to decide a section 10b-5 action challenging that disclosure." *Reiss*, 711 F.2d at 14.

The reasons for the "price and structure" standard of materiality disappear when there is no public market for a shareholder's stock. Both parties agree that in 1975 Joseph, Ralph, or Everett could dispose of his stock only if Hyman-Michaels bought it back or some outside entity bought the entire Company. Since there was no public market where one of the three could sell the minority interest that he owned or controlled, there was no possibility that disclosing the contacts with Goldman, Sachs and with Littlejohn would result in speculative investment in Hyman-Michaels's stock. Furthermore, Ralph and Everett did not need to make a public announcement in order to inform all the stockholders; they merely had to tell Joseph, who was there with them on January 27, 1976 and about to sell them his stock. There was also no danger that disclosure would mislead Joseph. If Joseph had a question about what Littlejohn or Goldman, Sachs said, he could simply ask Ralph and Everett and they could clarify any possibly misleading statement. Thus Joseph had a right as a shareholder to know about corporate developments, but there was no offsetting need to protect other shareholders and investors from potentially misleading disclosure. *Cf. Staffin*, 672 F.2d at 1205-07. We therefore decline to apply the "price and structure" rule of *Greenfield* in this case.

Although we agree with the appellee that preliminary merger negotiations may be material when there is no public market for the company's stock, we disagree with his suggestion that a more subjective standard of materiality applies when the corporation is closely-held.[3] *TSC*

[3] The appellants argue that the district court erred by applying a subjective standard of materiality when it ruled on

(Footnote continued on following page)

Industries teaches that the test of materiality is always an objective one. 426 U.S. at 445; *see also Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963). Even with the objective test, however, the fact that the corporation is small and closely-held may affect the materiality of an omitted fact in two respects. First, an event of a given magnitude probably has a larger potential impact on the fortunes of a small company than on the fortunes of a large one. *See SEC v. Geon Industries, Inc.*, 531 F.2d at 47-48. In addition, what the reasonable shareholder considers important is necessarily a function of his options. The "total mix" of information available to the reasonable shareholder includes the probability of being locked into a minority interest of an unprofitable, closely-held corporation. *See, e.g., Thomas v. Duralite Co.*, 524 F.2d 577, 581, 584-85 (3d Cir. 1975)(defendant gave plaintiff the impression that the company faced imminent disaster). Thus, although we apply the objective standard of materiality, the significance the reasonable shareholder would give a particular omitted fact depends on the circumstances confronting him. *See TSC Industries*, 426 U.S. at 449 ("a substantial likelihood that, *under all the circumstances*, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder") (emphasis added); *see also* 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 61.02[b][ii], at 3-131 (2d ed. revised December, 1984) ("the hypothetical reasonable man should be presumed to be standing in the plaintiff's shoes").

On January 27, 1976, Joseph had only two options—he could sell his stock to the Company for $300 per share or he could hope that some outside entity would buy Hyman-

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[5] *continued*

appellants' motion for a j.n.o.v. or a new trial. We agree that the district court applied an inappropriate test of materiality. Nevertheless, the court correctly instructed the jury with the objective test of materiality and applied the subjective standard only when ruling on the motion for a j.n.o.v. *See infra* pp. 25-26. Since we hold that the district court could not have granted a j.n.o.v. under the objective standard, the district court's error is not reversible.

Michaels at a higher price. If Joseph had decided not to sell and no other company acquired Hyman-Michaels, Joseph would have been the unemployed owner of a minority interest for which there was no market and that paid no dividends. *See* Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 Minn. L. Rev. 1, 37-38 n.118 (1982) (discussing the "essentially unmarketable character of minority interests in close corporations"). We therefore must consider whether the withheld information about Littlejohn and Goldman, Sachs would have assumed actual significance in the deliberations of the reasonable shareholder owning such a minority interest.

The defendants argue that no jury reasonably could find that Hyman-Michaels's contacts with Goldman, Sachs and Ralph's conversations with Angus Littlejohn were material facts for purposes of Rule 10b-5. We agree that the contact with Goldman, Sachs was not a material fact. Viewing the evidence in the light most favorable to Joseph, as we must, the evidence supports a finding that Ralph and Everett sent Charles Aaron to Goldman, Sachs to discuss (without revealing Hyman-Michaels's identity) whether Goldman, Sachs would be interested in finding a buyer for a small, closely-held company. In addition, Ralph told Angus Littlejohn that Ralph and Everett were considering retaining Goldman, Sachs to find a buyer for Hyman-Michaels. Nonetheless, on January 27, Aaron had not revealed Hyman-Michaels's identity to Goldman, Sachs and Goldman, Sachs had no way to assess the Company's salability. We therefore hold that the withheld information about the contact with Goldman, Sachs was immaterial as a matter of law.

On the other hand, a jury could reasonably find that Littlejohn's agreement to contact prospective buyers on behalf of Hyman-Michaels was material. Viewing the evidence in the light most favorable to the plaintiff, Ralph and Everett knew that Angus Littlejohn, who had visited

the Company with John Samuels in September, 1975 when Samuels discussed the possibility of ICM buying Hyman-Michaels for $12 to $14 million, had agreed to contact some prospective buyers on behalf of Hyman-Michaels. Ralph's comment that Littlejohn should "get [his] ducks lined up," together with Littlejohn's actions after the January 24 meeting,[4] support a finding that Ralph retained Littlejohn as a broker on January 24, 1976. Furthermore, although Ralph thought his conversations with Littlejohn were important enough to report to Everett and the other Company officers and advisors who met on January 26, 1976, neither Ralph nor Everett told Joseph, the only other major stockholder, about these developments.[5] *See SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 851 (2d Cir. 1968) ("[A] major factor in determining whether the [information] was a material fact is the importance attached to the [information] by those who knew about it."), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). Finally, Ralph and Everett refused Joseph's request that the stock purchase agreement be signed on January 27 but the closing be delayed six weeks so that Joseph might be able to complete his negotiations with the Harris Bank and buy the Company from Ralph and Everett. They did not, Ralph testified, want to give Joseph an extension that "might interfere with any future plans [they] may have for the sale of Hyman-Michaels." In short, a jury could reasonably find that on January 27 Ralph and Everett knew—but did not disclose to Joseph—that the prospects for selling Hyman-Michaels were the brightest since the Commercial Metals negotiations had collapsed. To the reasonable shareholder standing in Joseph's shoes, this would clearly be a material fact.

The defendants also argue that the withheld information was immaterial as a matter of law because Joseph knew that Hyman-Michaels was for sale and he knew that

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[4] *See infra* pages 20-21.

[5] There were other stockholders besides Ralph, Everett, and Joseph, but Ralph and Everett controlled the stock of these other stockholders.

Ralph had gone to Europe to "stir up" interest in Hyman-Michaels. Ralph had promised, however, to tell Joseph of any developments in Europe. In light of this promise, we think a reasonable shareholder would interpret Ralph's failure to mention any developments—especially since Al Moeng told Joseph that "nothing" happened in Europe—as a sign that Ralph had no success. This fact distinguishes the present case from *Hassig v. Pearson*, 565 F.2d 644, 649-50 (10th Cir. 1977). In *Hassig*, the Tenth Circuit held that the majority shareholder of a bank need not disclose general inquiries about purchasing the bank since he told the minority shareholder that he (the majority shareholder) was thinking about retiring and selling his majority interest. *Id.* at 649. Thus in *Hassig* the majority shareholder disclosed that he intended to end his many years as majority owner and officer of the bank and sell his interest. Here Ralph and Everett disclosed neither their proposed change in approach (using Littlejohn as a broker) nor the prospects that Littlejohn would contact on behalf of Hyman-Michaels. Knowledge that Hyman-Michaels was for sale would not aid the reasonable shareholder's deliberations if the shareholder did not know about the change in approach or the brightened prospects.

The defendants' reliance on *James Blackstone Memorial Library Association v. Gulf, Mobile and Ohio Railroad*, 264 F.2d 445 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959) is also misplaced. In that case, minority shareholders complained that the majority shareholder failed to disclose its intent to sell some of the company's assets at a favorable price. *Blackstone* was unique, however, in that the company had leased all its assets to another company in perpetuity. In exchange, the lessee promised to pay an annual dividend of $7 per share on the lessor's stock. The special master found, and this court agreed, that even if the minority shareholders had not sold their stock, they would still receive only the $7 annual dividend and would not have enjoyed any increase in the value of their stock. *Id.* at 452-53. Since the sale of assets would have no effect on the value of the stock, knowledge of the prospective sale would not alter the "total mix" of information consid-

ered by the reasonable shareholder. In contrast, the shareholders of Hyman-Michaels would—and did—enjoy the profits of selling the Company's assets for more than their book value.

For these reasons, a reasonable jury could find that, under all the circumstances, there was a substantial likelihood that the withheld information about Littlejohn would have assumed actual significance in the deliberations of the reasonable shareholder. *TSC Industries*, 426 U.S. at 449. The defendants were therefore not entitled to a judgment notwithstanding the verdict on the ground that no reasonable jury could find the omission material. *Selle v. Gibb*, 741 F.2d 896, 900 (7th Cir. 1984).

B.

To prevail on a section 10(b) or Rule 10b-5 claim, a plaintiff must also prove scienter—an intent to deceive. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976). Since defendants argue that there was no evidence of scienter, we examine the record to determine whether a jury could reasonably find that Ralph and Everett knowingly or recklessly withheld (or misstated) material information. *See Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792-93 (7th Cir. 1977).

The defendants argue there was no evidence of scienter because Ralph thought the bank said "no" and because Ralph and Everett did not think the withheld information about Littlejohn was important. We quickly dismiss the first argument because Ralph testified at trial that Simons (the Continental Bank loan officer) told him the bank would not loan the $3 million or the $4 million unless Ralph gave a personal guarantee. Ralph also testified that he told Everett the bank wanted Ralph's personal guarantee but only told Joseph that the bank said "no" and that Joseph was "out" of Hyman-Michaels. Since the evidence clearly supported a finding that Ralph knowingly misstated the bank's answer, a jury could reasonably infer

that Ralph intended to deceive Joseph with the falsehood. *Cf. Sanders*, 554 F.2d at 792.

The plaintiff also offered sufficient evidence for a jury to find that the defendants possessed scienter with respect to the omissions. Ralph thought his discussions with Littlejohn were important enough to report to Everett and the Company's lawyers at their January 26 meeting. Nonetheless, neither Ralph nor Everett mentioned Littlejohn when they met with Joseph to buy his stock on January 27.

A finding of scienter is also supported by Ralph and Everett's January 27th refusal to extend the closing date beyond January 30. True, it is the date the parties sign the agreement, not the closing date, that is relevant for determining materiality and scienter. *See Radiation Dynamics*, 464 F.2d at 891. But their refusal to extend the closing date and the subsequent explanations of that refusal are relevant to prove their intent on January 27, 1976. Ralph and Everett knew that Joseph and Fuerst had met with the Harris Bank and were trying to obtain a loan so Joseph could buy Hyman-Michaels. They refused to extend the closing date because, as Ralph testified, allowing Joseph a six-to-eight week extension for the purpose of allowing Joseph to obtain financing "might interfere with any future plans" for the sale of Hyman-Michaels. Therefore, viewing the facts in the light most favorable to the plaintiff, we think a jury could reasonably find that Ralph and Everett possessed the requisite scienter when they purchased Joseph's stock on behalf of the Company. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983) (scienter can be inferred from circumstantial evidence).

C.

Finally, appellants assert that the judgment for the plaintiff must be reversed because Joseph's claim cannot satisfy the reliance element of a section 10(b) claim. The

defendants contend that Joseph failed to prove he had relied on Ralph's misstatement about the bank and that they proved that Joseph would have sold his stock for $300 a share even if he had known about Littlejohn.

When a plaintiff bases a section 10(b) or a Rule 10b-5 claim on a misrepresentation, he must prove that he was induced to act by the defendant's misstatement. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 547-48 (5th Cir.), *modified*, 650 F.2d 815 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). The defendants in this case claim that Joseph's theory of reliance is premised on a fact that was contradicted by the proof. They argue that Joseph offered no credible evidence of reliance and that he therefore cannot succeed on the misrepresentation claim. We disagree. Joseph testified at trial that he would not have agreed to sell his stock for $300 per share if he had known that Continental Bank did not say "no" to the request for a loan to buy both Everett's and Joseph's stock. In addition, Joseph's attempt to obtain financing from the Harris Bank so he could buy Hyman-Michaels—an attempt that continued until he sold his stock—suggests that Joseph believed Ralph's statement and, consequently, looked for alternative methods of protecting his minority interest in the Company. From this evidence, a jury could reasonably find that Ralph's statement that the bank said "no" was relied upon by Joseph in his decision to forego his request that his stock be bought with Everett's and instead to sell only his stock to the Company.

Turning to the withheld information about Littlejohn, we note that reliance is presumed when the plaintiff proves that the withheld information was material. *See Affiliated Ute Citizens*, 406 U.S. at 153-54; *Wright v. Heizer Corp.*, 560 F.2d 236, 249 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). A defendant can still prevent a plaintiff from recovering, however, if the defendant can prove that the plaintiff did not rely, that is, "that even if the material facts had been disclosed, plaintiff's decision as to the transaction would not have been different from what

it was." *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). In the present case, Ralph and Everett argue that telling Joseph about Littlejohn would not have affected Joseph's decision to sell because he was heavily in debt and, "having been effectively dismissed from Hyman-Michaels on January 5," without a job. The plaintiff stipulated at trial that without his job at Hyman-Michaels he was "between a rock and a hard place." In addition, the defendants introduced into evidence memos written by Joseph's banker that stated that in January, 1976 Joseph owed approximately $195,000 to the First National Bank of Chicago and approximately $50,000 to the Marina City Bank. These memos are far from the conclusive proof that the defendants claim them to be; two of these memos also stated that Joseph owned approximately $225,000 in liquid, non-Hyman-Michaels securities. Since the omissions were material, the defendants bore the burden of proving no reliance, *see Huddleston*, 640 F.2d at 548, and we do not think that they conclusively proved that Joseph had no choice but to sell his stock for $300 per share on January 27, 1976. Viewing the evidence in the light most favorable to the plaintiff, a jury could reasonably find that, even though Joseph was "between a rock and a hard place," he would have postponed signing the agreement or demanded a higher price if he had known about the contacts with Littlejohn.

III.

Appellants challenge several evidentiary rulings made by the trial court. They claim that the trial court erred in admitting (1) evidence concerning Littlejohn's activities after his luncheon meeting with Ralph Michaels on January 24, 1976; (2) telexes sent by Littlejohn to Samuels and responses by Samuels; and (3) testimony about the January 28, 1976 telephone conversation between Ralph and Littlejohn. According to defendants, all this evidence is irrelevant and highly prejudicial and the

telexes are also inadmissible hearsay. The defendants also challenge the exclusion of some of their evidence on the damages issue.

Evidence is relevant if it has "any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401. A district court can, in its discretion, exclude relevant evidence if the probative value of the evidence "is substantially outweighed by the danger of unfair prejudice." Fed. R. Evid. 403. On appeal, we accord "great deference" to the district court's decision on admissibility. *See United States v. Medina*, 755 F.2d 1269, 1274 (7th Cir. 1985).

In the present case, the plaintiff offered evidence of Littlejohn's activities after January 24, 1976 to prove that Ralph and Littlejohn agreed at the January 24 luncheon that Littlejohn would act as a broker for Hyman-Michaels. Littlejohn's activities, the plaintiff argued, revealed that Littlejohn acted as if he were the Company's broker and are therefore consistent with Joseph's contention that Ralph and Littlejohn reached an agreement on January 24. This theory of admissibility also supports the relevance of the telex Littlejohn received from Samuels on January 26, 1976. Rather than follow Samuels's instruction to explore whether ICM could purchase Hyman-Michaels, Littlejohn instead contacted Dov Gottesman, an industrialist Littlejohn had mentioned to Ralph on January 24, 1976. Littlejohn's response to the telex thus suggests that he was more concerned with the sale of Hyman-Michaels than with any potential benefit to ICM. Consequently, we think the probative value of the evidence clearly outweighed any danger of unfair prejudice.

As for the other evidence, the January 23, 1976 telex to Samuels described Littlejohn's phone conversation with Ralph and Littlejohn's intention to establish himself as a broker for Hyman-Michaels. Thus the telex is relevant as it shows the course of action leading up to the alleged January 24 agreement. The district court also found

Littlejohn's phone conversation with Ralph on January 28, 1976 and the subsequent telex to Samuels tended to confirm or clarify the agreement made on January 24. The court concluded that even though these communications occurred after the January 27 signing of the agreement, they were relevant and admissible because they tended to make the existence of a January 24 agreement more probable than it would be without this evidence. Balancing the probative value and the danger of unfair prejudice of evidence is within the discretion of the trial court, and we do not think the court abused its discretion.

The defendants also argue that the telexes were inadmissible hearsay. At trial, the plaintiff countered that the telexes by Littlejohn were admissible under Fed. R. Evid. 801(d)(2)(D) (statement by an agent of the party) and that the January 23, 1976 telex from Samuels was not offered to prove the truth of the matter asserted. We think the telexes sent by Littlejohn after his lunch with Ralph are not hearsay because, even if a broker is not an agent for purposes of Rule 801(d)(2)(D), Littlejohn's statements concerned the possible sale of Hyman-Michaels. Viewing the other evidence in the light most favorable to the plaintiff, Ralph authorized Littlejohn to act as the Company's broker and contact Samuels and other potential buyers. Thus these telexes are statements by a person authorized to make a statement about the subject and are admissible under Fed. R. Evid. 801(d)(2)(C). Of course, the plaintiff does not claim that Ralph authorized Littlejohn to act for Hyman-Michaels on January 23, 1976, so Littlejohn's telex of that date cannot be admitted under Rule 801(d)(2)(C). But Littlejohn stated in the telex "Ralph Michaels . . . just told me" and, although he later equivocated, Littlejohn testified in his deposition (which was read at trial) that he sent the telex "immediately" after his conversation with Ralph. Therefore, although the district court did not give a reason why he overruled the hearsay objection, the court would not have abused its discretion by admitting it as a present sense impression under Fed. R. Evid. 803(1).

Turning to the telexes from Samuels, we believe the district court correctly admitted the telex sent on January 23, 1976 and received by Littlejohn on January 26, 1976. As we noted in discussing its relevance, the plaintiff argued that the telex was offered not to prove that David Lloyd-Jacob was interested or that Samuels thought ICM should buy Hyman-Michaels but rather to show Littlejohn's response to this information. Thus the first telex from Samuels, because it was not offered to prove the truth of the matter asserted, was not hearsay. Fed. R. Evid. 801(c). The telex from Samuels to Littlejohn on January 28, 1976, which stated "Proceed with contact of Lloyd-Jacob," appears to be hearsay and not within any exception. To the extent the district court erred in admitting this evidence, we find the error harmless. Fed. R. Civ. P. 61.

Finally, the defendants argue that the district court erred in excluding evidence about events occurring after Joseph sold his stock but affecting the final liquidation value of Evra Corporation stock.[4] Plaintiff's expert, Howard Doherty, testified that a post-January 27, 1976 event, the sale of Hyman-Michaels's assets to Azcon, affected the value of Joseph's stock on January 27, 1976. The defendants then tried to ask one of their expert witnesses, Carl Ruzicka, about events occurring between July, 1976 and October, 1983 that affected the liquidation value of Evra Corporation. The plaintiff objected, claiming that Ruzicka should not be permitted to testify about expenses incurred by Evra in defending the present lawsuit. The plaintiff also contended, and the district court seemed to agree, that Joseph could not be charged with management decisions occurring after January 30, 1976 that affected the value of the stock. The district court did, however, allow Ruzicka to testify that, after Evra Corporation liquidated its assets and liabilities, approxi-

[4] As part of the sale of assets to Azcon, Hyman-Michaels sold its name to Azcon and changed its corporate name to Evra Corporation.

mately $8.6 million, or $427.65 a share, was distributed to the shareholders. We think the district court did not abuse its discretion in excluding evidence of events occurring between July, 1976 and October, 1983. The court could reasonably find that the danger of confusion or unfair prejudice substantially outweighed the probative value of testimony about events occurring as late as six and one-half years after Joseph sold his stock. *See Medina*, 755 F.2d at 1274 (district court ruling is given "great deference").

IV.

Ralph and Everett argue that the trial court should have granted them a new trial. Since a motion for a new trial is addressed to the sound discretion of the trial court, we may reverse the trial court's decision only for an abuse of discretion. *See Spesco, Inc. v. General Electric Co.*, 719 F.2d 233, 240 (7th Cir. 1983).

The defendants first argue that we should reverse the district court's denial of their motion for a new trial because that court applied the more stringent judgment notwithstanding the verdict standard when ruling on their motion. As the defendants correctly point out, the court's order used the language of the j.n.o.v. standard in rejecting the defendants' argument that the withheld and misrepresented information was not material. Nevertheless, we do not believe the court erred.

The defendants flooded the district court with thirty-four reasons, not counting sub-parts, why the district court should grant a j.n.o.v. or, in the alternative, a new trial. In its order disposing of the motion, the district court stated that only a few of these numerous arguments warranted discussion. The court then summarized the defendants' argument on materiality as follows: "Defendants contend the court should have ruled as a matter of law that the enumerated omissions and misrepresentations were not material to the plaintiff's in-

vestment decision." Nothing in the district court's discussion of the issue suggests that the district court denied the motion for new trial on the ground that the defendants could not meet the j.n.o.v. standard. Instead, it appears that, since the defendants stressed in their memorandum in support of the motion that the information was immaterial *as a matter of law*, the district court decided that the issue whether the true information was immaterial as a matter of law warranted discussion but that whether the verdict was against the clear weight of the evidence did not. This explanation seems especially likely since the district court used language appropriate for deciding a motion for a new trial in discussing the defendants' arguments that inconsistent verdicts, inflammatory comments in closing argument, and an excessive damage award necessitated a new trial. It seems highly improbable that in one order the district court would apply the wrong standard for a new trial motion in discussing the first issue and then apply the correct standard for the remaining issues. We believe the district court concluded that the defendants' argument for a new trial did not justify discussion. Having reviewed the record, we conclude that there was evidence sufficient to support a finding of materiality and therefore the district court did not abuse its discretion in denying the defendants' motion for a new trial on this ground. *See Rey v. City of Fredericktown, Missouri*, 729 F.2d 1171, 1174 (8th Cir. 1984).

Nor did the district court abuse its discretion in rejecting the defendants' arguments that inconsistent verdicts and inflammatory comments in closing argument mandated a new trial. The district court instructed the jury that Hyman-Michaels Company was responsible for any act or omission of an officer or employee within the scope of his employment. The jury verdicts against Ralph and Everett but in favor of the Company were consistent, as the district court reasoned, because the jury could have found that Ralph and Everett acted for their personal benefit and not in their corporate capacities. Evidence that the Hyman-Michaels Board of Directors never passed

a resolution concerning the consent agreement or authorizing Marvin Chapman to reject Joseph's proposals on January 4, 1976 and January 27, 1976 supports this conclusion.

As to the alleged inflammatory comments by plaintiff's counsel in closing argument, the comments do not constitute fundamental trial error and therefore defense counsel's failure to object precludes the defendants from assigning the comments as error. *See Gonzalez v. Volvo of America Corp.*, 752 F.2d 295, 298 (7th Cir. 1985). As we stated in *Gonzalez*, "risky gambling tactics such as [not objecting] are usually binding on the gambler." *Id.* This is especially true in the present case, since the defense counsel not only failed to object but also said in his opening argument that Joseph had "abandoned and deserted" his first wife and called Joseph "sly, avaricious, and greedy" in both his opening and closing arguments. The defendants gambled on a trial strategy and lost, and the district court did not abuse its discretion in refusing to grant a new trial for comments to which the defendants did not object.

Finally, the defendants argue that the plaintiff offered no credible evidence to support the jury's award of $750,000 in compensatory damages and $200,000 in punitive damages. Howard Doherty, the plaintiff's damages expert, testified that he estimated the value of Joseph's stock as $1,823,011, or $915,928 more than Joseph received. He obtained this estimate by starting with $9,397,490, the book value (or shareholders' equity) for common stock and convertible debentures. To this figure he added the gain on the sale of assets to Azcon ($3,391,486) and the actuarial value of Ralph's and Everett's lifetime employment contracts with Azcon ($382,681). Doherty testified that under this approach Joseph's stock was worth $600.27 a share rather than the $300 he received.

The trial court stated in its order denying the motion for a new trial that the "court, and apparently the jury, found plaintiff's expert to be credible in arriving at a

damage figure." True, the jury awarded $750,000 rather than the $915,928 Doherty estimated, but the jury was not bound by Doherty's estimate and was entitled to make its own estimate of damages. In any event, the verdict does not suggest "a runaway jury or one that lost its head" and therefore the district court did not abuse its discretion in denying a new trial on compensatory damages. *See Grunenthal v. Long Island Railroad*, 393 U.S. 156, 160 (1968); *Spesco*, 719 F.2d at 240-41.

With respect to punitive damages, the defendants argue that the court should not have submitted the issue to the jury because the record contains no credible evidence of willful and wanton conduct. We disagree. Under Illinois law, the function of punitive damages is to punish the wrongdoer and deter both him and others from committing like offenses in the future. *See Kelsay v. Motorola, Inc.*, 74 Ill. 2d 172, 188, 384 N.E.2d 353, 360 (1978). Thus Illinois courts have long recognized that punitive damages are appropriate when torts are committed with fraud or actual malice or when the defendant acts willfully or with a wanton disregard for the rights of others. *Id.* at 186. In the present case, the plaintiff offered evidence showing, among other things, that Ralph lied to Joseph about the bank loan, that Joseph was "out" of Hyman-Michaels as far as Everett and Ralph were concerned, that Everett and Ralph withheld information about Angus Littlejohn, and that Everett and Ralph refused to give Joseph more time to negotiate a loan so Joseph could buy the Company. If believed, this evidence supports a finding that Everett and Ralph intentionally defrauded Joseph and justifies an award of punitive damages. *See Durant v. Surety Homes Corp.*, 582 F.2d 1081, 1088 (7th Cir. 1978) ("the transcript of a trial in a fraud case will seldom reveal admissions by the defendant that his conduct was not only fraudulent but intentionally, willfully, or recklessly so"). Therefore the district court properly submitted the issue to the jury and the court did not abuse its discretion in denying the motion for a new trial. We similarly refuse to substitute our judgment for that of the jury. *See McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 474 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

V.

Prejudgment interest is a form of compensation and the decision to award prejudgment interest rests in the sound discretion of the district court. *See Myron v. Chicoine*, 678 F.2d 727, 733-34 (7th Cir. 1982); *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1075 (7th Cir. 1975), *vacated and remanded on other grounds*, 425 U.S. 929 (1976). That decision requires a balancing of the equities between the parties under the circumstances of the particular case. *Myron*, 678 F.2d at 734. In the present case, defendants challenge the award of prejudgment interest on the grounds that Joseph is responsible for part of the delay and that a juror stated in an affidavit that the $750,000 award included prejudgment interest.

The defendants suggest that the court should not have assessed interest against them for the time between Joseph's loss and the date he filed his complaint in this lawsuit. They cite no case authority for this proposition, however, and our research has uncovered no cases. Indeed, this court has awarded prejudgment interest from the date of the loss. *See Sundstrand*, 553 F.2d at 1051; *see also Sanders*, 524 F.2d at 1075 ("unless the plaintiff is paid interest for the entire time that he is deprived of the use of his money, he will not receive full compensation"). Although Joseph did wait more than two years before filing his complaint, the district court specifically found that "the extended delay [more than eight years] between the loss and final judgment was not caused by any dilatory tactics by the plaintiff" and that there were "no countervailing equitable considerations making the award unfair to the defendants." A plaintiff's delay in filing an action, and the reason for the delay, may be considered by the district court when balancing the equities and awarding prejudgment interest. In the present case, we believe the district court properly balanced the equities and did not abuse its discretion in awarding prejudgment interest from the date of Joseph's loss.

The defendants also challenge the district court's refusal to consider a juror's affidavit that said the jury had included prejudgment interest in the $750,000 compensatory damages award. Defendants argue that, since an award of prejudgment interest is based on fairness and equitable considerations, the district court should have considered the affidavit. We disagree.

Rule 606(b)[1] of the Federal Rules of Evidence precludes a juror from testifying about jury deliberations. This rule was designed to protect the jury's deliberative process—including jurors' statements, mental and emotional reactions, and votes. Fed. R. Evid. 606(b); *Wiedemann v. Galiano*, 722 F.2d 335, 337 (7th Cir. 1983). As the Supreme Court stated, if jurors were competent to impeach their verdict, they "would be harassed and beset by the defeated party in an effort to secure from them evidence of facts which might establish misconduct sufficient to set aside a verdict." *McDonald v. Pless*, 238 U.S. 264, 267-68 (1915). We recognize that if the affidavit is true the plaintiff will receive an undeserved bonanza in the form of the district court's award of prejudgment interest. Nevertheless, we believe that allowing a juror's affidavit to influence a district court's opinion on pre-

[1] That rule provides as follows:

> Upon an inquiry into the validity of a verdict or indictment, a juror may not testify as to any matter or statement occurring during the course of the jury's deliberations or to the effect of anything upon his or any other juror's mind or emotions as influencing him to assent to or dissent from the verdict or indictment or concerning his mental processes in connection therewith, except that a juror may testify on the question whether extraneous prejudicial information was improperly brought to the jury's attention or whether any outside influence was improperly brought to bear upon any juror. Nor may his affidavit or evidence of any statement by him concerning a matter about which he would be precluded from testifying be received for these purposes.

Fed. R. Evid. 606(b).

judgment interest presents much the same problem as permitting an affidavit to support a motion for a new trial—a context in which we have already held a juror's affidavit to be incompetent under Rule 606(b). *See Wiedemann*, 722 F.2d at 337. The defendants' attempt to characterize part of the $750,000 as prejudgment interest is in essence an attempt to impeach the award; therefore the district court properly refused to consider the affidavit. *See Wilsmann v. Upjohn Co.*, 572 F. Supp. 242, 244-45 (W.D. Mich. 1983) (juror's affidavit not considered by court when awarding prejudgment interest).

VI.

Finally, the defendants claim that the district court should not have directed a verdict for the plaintiff on Hyman-Michaels's counterclaim. That counterclaim, which alleged that by bringing the present lawsuit Joseph had breached ¶ 7 of the January 27, 1976 agreement, sought damages to compensate the Company for the cost of defending the present action.

Although the parties agreed during trial not to offer evidence as to the amount of attorneys' fees incurred, the January 27, 1976 agreement was entered into evidence. That agreement only stated that Joseph released the Company "from any and all obligations, claims, demands, liabilities, actions, and causes of action" which Joseph then had; it made no mention of attorneys' fees or costs in the event of a breach. This omission is fatal to the Company's counterclaim since, under Illinois law, attorneys' fees and the ordinary expenses of litigation are not allowable to the successful party absent a statute or contractual agreement. *See Kerns v. Engelke*, 76 Ill. 2d 154, 166-67, 390 N.E.2d 859, 865 (1979); *Qazi v. Ismail*, 50 Ill. App. 3d 271, 273, 364 N.E.2d 595, 597 (1977). Therefore the district court properly directed a verdict for the plaintiff on the Company's counterclaim. *Cf. Ferrara v. Collins*, 119 Ill. App. 3d 819, 825, 457 N.E.2d 109, 113 (1983).

VII.

For the foregoing reasons, we affirm the awards of $750,000 in compensatory damages and $200,000 in punitive damages. Since we affirm these awards on the bases of the Rule 10b-5 and common-law fraud claims,[8] we need not discuss the defendants' challenges to the jury verdict on the fiduciary duty count. We also affirm the award of prejudgment interest and the directed verdict for the plaintiff on the counterclaim. The judgment of the district court is

AFFIRMED.

A true Copy:
Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

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[8] The defendants direct no arguments specifically to the common-law fraud count and so we presume that they would urge reversal of the fraud count for the same reasons they offer for reversal of the section 10(b) count. Under Illinois law, the elements of a cause of action for fraud are the following: (1) a false statement of material fact, (2) known or believed to be false by the party making the statement, (3) an intent to induce the other party to act, (4) action by the other party in reliance on the truth of the statement, and (5) damage to the other party as a result of that reliance. *See Soules v. General Motors Corp.*, 79 Ill. 2d 282, 286, 402 N.E.2d 599, 601 (1980). Omission of a material fact, when accompanied by scienter, deception, and injury, can also constitute fraud under Illinois law. *See Perlman v. Time, Inc.*, 64 Ill. App. 3d 190, 195, 380 N.E.2d 1040, 1044 (1978). For the reasons given in our discussion of the section 10(b) count, we hold that a jury could reasonably find the defendants liable for common-law fraud.

USCA 50234—Pandick Midwest, Inc., Chicago—9-9-85—450

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 84-1631, 84-1714

JOSEPH MICHAELS,

Plaintiff-Counterdefendant-Appellee,

v.

RALPH MICHAELS, EVERETT B. MICHAELS and HYMAN-MICHAELS COMPANY,

Defendants-Counterplaintiffs-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 78 C 3274—Stanley J. Roszkowski, *Judge.*

ARGUED FEBRUARY 21, 1985—DECIDED JULY 3, 1985

Before WOOD and FLAUM, *Circuit Judges*, and BROWN, Senior District Judge.*

WOOD, *Circuit Judge.* This case involves a family squabble between the plaintiff Joseph Michaels and his uncles, defendants Ralph Michaels and Everett Michaels.[1] Joseph claims that when he sold his stock in the family business, the Hyman-Michaels Company ("the Company"), to the Company in January of 1976, his uncles misstated and withheld material information that, if revealed, would have affected his decision to sell. Joseph

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* The Honorable Wesley E. Brown, Senior District Judge for the District of Kansas, is sitting by designation.

[1] To avoid confusion about which of the Michaels we are referring to, we will refer to them by their first names.

subsequently brought this action, alleging that his uncles and the Company had violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and had committed common-law fraud. Joseph's complaint also charged his uncles with a breach of a fiduciary duty and the Company with a breach of the warranty provision of the contract for the sale of stock. The parties tried the case before a jury in November, 1983, and the jury found for Joseph and against his uncles on the 10b-5, fiduciary duty, and common-law fraud claims, but against Joseph and for the Company on the 10b-5 and warranty claims. The jury assessed damages at $750,000 and also awarded Joseph $200,000 in punitive damages on the common-law fraud claim. The district court subsequently denied defendants' motion for judgment notwithstanding the verdict or a new trial, awarded Joseph prejudgment interest, and directed a verdict for Joseph on the Company's counterclaim.

This appeal raises a number of issues. The defendants argue that they did not violate section 10(b) or Rule 10b-5 because (1) the withheld information was immaterial as a matter of law, (2) they did not possess the requisite scienter, and (3) the plaintiff did not rely on any misstatement and would have sold his stock even if he had known the withheld information. The defendants also challenge several of the district court's evidentiary rulings, its denial of their motion for a new trial, and the directed verdict for the plaintiff on the Company's counterclaim. We affirm.

I.

The Hyman-Michaels Company was in the business of purchasing, processing, and distributing scrap iron and steel. In mid-1975, Everett owned or controlled approximately fifty percent of the outstanding voting common stock of Hyman-Michaels, Ralph owned or controlled approximately thirty-six percent, and Joseph owned fourteen percent. On January 27, 1976, Joseph agreed to sell

his shares to the Hyman-Michaels Company for three hundred dollars a share. Three days later, Joseph delivered the stock, resigned from his offices in the Company, and received $981,276.73. In July, 1976, Everett and Ralph sold the assets of the Company for approximately $13.4 million plus lifetime employment contracts. Joseph claims that Everett and Ralph withheld three material facts from him: (1) that the Continental Illinois National Bank ("Continental Bank") had not said "no" to the Company's loan request; (2) that Everett and Ralph decided to retain a professional financial firm to obtain a purchaser for Hyman-Michaels's assets; and (3) that Ralph had met with Angus Littlejohn in London and that Littlejohn had agreed to contact some prospective purchasers.

A.

Between 1966 and 1976, Hyman-Michaels negotiated with approximately ten different companies in unsuccessful attempts to sell either the Company's assets or the stock owned or controlled by Ralph, Everett, and Joseph. In mid-summer 1975, Ralph began discussions with the Commercial Metals Company ("Commercial Metals") designed to effect a sale of the assets of Hyman-Michaels. The two parties discussed prices, based on asset value, of approximately $14 million. On September 5, 1975, while the Commercial Metals negotiations were ongoing, Ralph, Joseph, and Al Moeng (a Hyman-Michaels financial officer) met with Angus Littlejohn, a consultant to International Carbon & Minerals Corporation ("ICM"), and John Samuels, the chairman of ICM, to discuss the possibility of ICM acquiring Hyman-Michaels. A purchase price in the range of $12 to $14 million was mentioned, but Ralph terminated the meeting without further pursuing Samuels's proposal because Ralph felt that the ongoing discussions with another company (Commercial Metals) precluded such a dialogue. Ralph told Littlejohn and Samuels that he would contact them if negotiations with the other company fell through.

The Commercial Metals negotiations ended in December, 1975. Worried about Everett's health and the possible problems for Hyman-Michaels if Everett would die and his shares go into probate, Ralph suggested that the Company borrow money and buy back Everett's common stock for three hundred dollars per share. This price was less than the stock's book value, but Everett agreed to accept three hundred dollars because Ralph said that was all the Company could afford. Ralph and Al Moeng consequently contacted Bruce Simons, a loan officer at Continental Bank, about borrowing the approximately three million dollars needed to buy out Everett. Ralph also advised Joseph that all three shareholders would need to sign a "unanimous stockholders consent" before the Company could borrow money for Everett's shares.

While the Company was negotiating with Continental Bank for a loan, Ralph told Joseph that, after Everett's stock was purchased, Ralph would own or control about seventy-five percent of Hyman-Michaels's voting stock with Joseph owning approximately twenty-five percent of that stock. Ralph also said that he intended to place his wife and his son-in-law on Hyman-Michaels's Board of Directors when Everett left the Company. Joseph consequently became concerned about what would happen to his family if he or Ralph died, given Ralph's wife's apparent ill-will toward Joseph's wife. Joseph therefore sought advice from Harrison Fuerst, a friend who practiced law in Cleveland, Ohio. Fuerst suggested that Joseph ask Ralph to accept one of three proposals: (1) that Hyman-Michaels offer Joseph a buy-sell agreement for his stock; (2) that Ralph and Joseph place their stock in a voting trust so that each would have equal votes; or (3) as a last and least desirable alternative, that Hyman-Michaels purchase Joseph's stock at the same time and for the same price that it purchased Everett's stock.

Joseph and Fuerst presented these proposals to Ralph, Moeng, and Marvin Chapman, the Company's lawyer, on

January 4, 1976. Either Ralph or Chapman rejected the first two proposals, but Ralph agreed to ask Continental Bank for an additional one million dollars to buy Joseph's shares along with Everett's. Ralph said, however, that he thought Joseph's request would "kill the deal" and that, as far as Ralph was concerned, Joseph was "out" of Hyman-Michaels no matter what Continental Bank said. After this meeting, Ralph and Chapman went to Everett's house to report what had happened; Everett agreed that the Company should buy out Joseph. When Chapman related Joseph's desire not to be kicked out of the Company and lose his job, Everett responded, "I don't give a damn."

On January 5, 1976, Ralph and Moeng went to Continental Bank and requested the additional financing to buy Joseph's stock. Later that day, Simons told Ralph that the bank would not loan Hyman-Michaels either the three million dollars originally requested or the four million dollars unless the loan were secured with Ralph's personal guarantee. Moments later, Joseph was summoned to Moeng's office, where Ralph told him, "Joe, you're out. The bank has said no." Ralph reiterated that Joseph was relieved of all duties at Hyman-Michaels.

B.

Joseph also claims that Ralph and Everett never told him that they had decided to retain a professional financial firm to locate a purchaser for the Company. On January 5, 1976, Charles Aaron met briefly with James Hemphill and James Gorter of the investment firm of Goldman, Sachs & Co. ("Goldman, Sachs"). Aaron told Gorter only that he represented a company that might be interested in seeking a buyer. On January 24, 1976, Ralph told Littlejohn that Hyman-Michaels was considering retaining Goldman, Sachs. As it turned out, the Company never retained Goldman, Sachs or any other investment firm.

C.

The third alleged misrepresentation concerns Ralph's contact with Angus Littlejohn in London on the 23rd and 24th of January. Prior to his departure for Europe, Ralph told Joseph that he (Ralph) would try to reactivate interest in a purchase of Hyman-Michaels and promised to report any such interest to Joseph. On January 23, 1976, Ralph telephoned Angus Littlejohn and told him that Hyman-Michaels was no longer negotiating with Commercial Metals. Ralph asked Littlejohn if ICM and John Samuels were still interested in buying Hyman-Michaels. At Littlejohn's request, Ralph agreed to stay in London an extra day and meet Littlejohn for lunch.

After his telephone conversation with Ralph, Littlejohn sent the following telex to John Samuels in New York:

> RALPH MICHAELS OF HYMAN MICHAELS COMPANY CHICAGO, WHOM I AM SEEING TOMORROW, JUST TOLD ME THAT THE PROPOSED SALE OF THEIR COMPANY COLLAPSD [sic] RECENTLY AT THE VERY LAST MINUTE.
>
> I PRESUME THAT WE [ICM] WOULD NOT BE INTERESTED AT THIS STAGE BUT WOULD APPRECIATE YOUR OPINION AS TO WHETHER IT MIGHT APPEAL TO DAVID.
>
> IF THIS IS TO BE PURSUED PLEASE GIVE ME TIME TO FIRST ESTABLISH A POSITION AS BROKER WITH RALPH.

"David" referred to David Lloyd-Jacob, the executive director of Consolidated Gold Fields in North America ("Consolidated") and the president of Azcon Corporation ("Azcon"), who had toured Hyman-Michaels's Hegewisch yard with Ralph in 1974. By telex dated January 24, 1976, but not received by Littlejohn until January 26, 1976, Samuels responded, stating that Lloyd-Jacob "would

definitely be interested" but that Samuels first wanted the chance for ICM to buy Hyman-Michaels.

On January 24, 1976, Ralph had lunch with Littlejohn. Ralph repeated what he had told Littlejohn the day before and identified Goldman, Sachs as the investment banker Hyman-Michaels intended to retain. Littlejohn mentioned a number of companies that he thought might be interested in acquiring Hyman-Michaels, including Consolidated. Littlejohn then asked Ralph to exclude those companies—including Consolidated—from any agreement Ralph might reach with Goldman, Sachs so that Littlejohn could obtain a brokerage fee if he were able to effect the purchase of Hyman-Michaels by one of those companies. Ralph told Littlejohn: "Get your ducks lined up."

On January 26, 1976, Ralph had a luncheon meeting with Everett and Hyman-Michaels's lawyers, Aaron and Chapman. Ralph told the others about his meeting with Littlejohn and described the companies, including Consolidated, that Littlejohn had indicated were potential purchasers of Hyman-Michaels. Joseph—still a stockholder, officer, and director of Hyman-Michaels—was not invited. Ralph told those gathered that Littlejohn was going to contact certain companies, including Consolidated, on behalf of Hyman-Michaels. The next day, still without telling Joseph of Ralph's conversations with Littlejohn, Ralph and Everett signed the agreement to buy Joseph's stock. In July, 1976, Ralph and Everett sold the Company's name and assets to Azcon for $13.4 million and lifetime employment contracts.

II.

Section 10(b) and Rule 10b-5 make it unlawful to misrepresent or fail to disclose material information in connection with the purchase or sale of securities. *See* 15 U.S.C. § 78j(b) (1982); 17 C.F.R. 240.10b-5 (1984); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128,

150-54 (1972). The defendants argue that the jury verdict on the section 10(b) and Rule 10b-5 claim must be overturned because the information withheld from Joseph was immaterial as a matter of law, because there was no evidence of scienter, and because Joseph did not rely on Ralph's alleged misstatement about the bank. The standard for determining whether the district court should have granted a judgment notwithstanding the verdict ("j.n.o.v.") is "whether the evidence presented, combined with all reasonable inferences permissibly drawn therefrom, is insufficient to support the verdict when viewed in the light most favorable to the party against whom the motion is directed." *Sywock v. Milwaukee Boiler Manufacturing Co.*, 665 F.2d 149, 153 (7th Cir. 1981).

A.

For purposes of section 10(b) and Rule 10b-5, an omission or misstatement is material if there is a "substantial likelihood that, under all the circumstances, the omitted [or misstated] fact would have assumed actual significance in the deliberations of the reasonable shareholder." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The materiality of the information misstated or withheld is determined in light of what the defendants knew at the time the plaintiff committed himself to sell the stock, in this case by signing the agreement to sell on January 27, 1976. *See Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 891 (2d Cir. 1972) (commitment to sell occurs when "the parties obligated themselves to perform what they agreed to perform even if the formal performance of their agreement is to be after a lapse of time"); *see also Goodman v. Epstein*, 582 F.2d 388, 411-12 (7th Cir. 1978) (quoting *Radiation Dynamics* with approval but distinguishing it on the facts), *cert. denied*, 440 U.S. 939 (1979). Thus activities occurring after January 27, 1976 are relevant to the materiality issue only to the

extent that they reflect what Ralph or Everett knew at the time they signed the stock purchase agreement.[2]

The defendants-appellants argue that under this objective test of materiality the discussions with Goldman, Sachs and Angus Littlejohn were immaterial as a matter of law. A number of cases support their generalization that preliminary merger discussions are immaterial. For example, in *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985), the Third Circuit held that merger negotiations do not become material until the merging companies agree on both price and the post-merger structure. *See also Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983). We agree that Ralph and Edward would have had

[2] The appellants also assign as error the district court's refusal to give their proposed instructions 9 and 10. Proposed instruction 9 stated, in part, that the jury "should not . . . determine the materiality of any omitted fact based on matters occurring after 1-27-76." Instruction 10 stated, in part, "Unless defendants had knowledge of material inside information on or prior to the commitment date, they were under no duty to the plaintiff to make any disclosure to the plaintiff or to abstain from buying the plaintiff's stock." We believe the trial court properly refused to give defendants' instruction 9 because, as we hold above, matters happening after January 27, 1976 were relevant to the extent that they reflect what defendants knew on January 27. As for instruction 10, we think the jury received the equivalent instruction from the trial judge when he told the jury:

> In order for the defendants' alleged misstatements and omissions to have been material within the meaning of the securities laws, they must have occurred in connection with the sale of his Hyman-Michaels stock. Thus, in order to satisfy the 'in connection with' requirement, the misstatements and omissions must have been known to the purchaser and must have occurred on or prior to Joseph's executing the contract on January 27, 1976.

See Beard v. Mitchell, 604 F.2d 485, 497-98 (7th Cir. 1979) (no error if requested instruction is given "in substance").

no duty to disclose the meetings with Littlejohn and Goldman, Sachs if Hyman-Michaels's stock were publicly traded, but we think the withheld information would have affected the decision to sell of a reasonable investor owning fourteen percent of Hyman-Michaels's stock.

With publicly-traded stock, disclosing preliminary merger discussions may induce investors to buy stock in the target company, causing the price of the stock to rise. Similarly, such disclosure may convince stockholders who would have otherwise sold their stock to hold it with the belief that the acquiring company would offer a higher price. If the merger negotiations subsequently fail—as they frequently do—the price of the target company's stock falls; investors who bought shares at inflated, pre-disclosure prices suffer a loss and shareholders who would have otherwise sold may find that they can no longer obtain even the pre-disclosure price. *See Greenfield v. Heublein, Inc.*, 575 F. Supp. 1325, 1336 (E.D. Pa. 1983), *aff'd*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985). Therefore, to avoid any misleading caused by disclosing that a company is discussing merger possibilities, courts have held that the existence of preliminary merger negotiations is immaterial as a matter of law. *See Reiss*, 711 F.2d at 14; *Staffin v. Greenberg*, 672 F.2d 1196, 1205-07 (3d Cir. 1982). The need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations, the courts reason, outweighs the right of shareholders to have notice of corporate developments important to their investment decisions. *Greenfield*, 742 F.2d at 756. As the Second Circuit noted, "[w]e have no doubt that had [the company] disclosed the existence of negotiations . . . and had those negotiations failed, we would have been asked to decide a section 10b-5 action challenging that disclosure." *Reiss*, 711 F.2d at 14. Thus, for publicly-traded stock, the shareholders' right to know outweighs the need to protect them from potentially misleading disclosures only when the negotiating parties have reached an agreement on price and structure. *Greenfield*, 742 F.2d at 756-57.

The "price and structure" threshold does not preclude a finding of materiality in the present case, however, because the reasons for that standard of materiality disappear when there is no public market for a shareholder's stock. Both parties agree that in 1975 Joseph, Ralph, or Everett could dispose of his stock only if Hyman-Michaels bought it back or some outside entity bought the entire Company. Since there was no public market where one of the three could sell the minority interest that he owned or controlled, there was no possibiity that disclosing the contacts with Goldman, Sachs and with Littlejohn would result in speculative investment in Hyman-Michaels's stock. Furthermore, Ralph and Everett did not need to make a public announcement in order to inform all the stockholders; they merely had to tell Joseph, who was there with them on January 27, 1976 and about to sell them his stock. There was also no danger that disclosure would mislead Joseph. If Joseph had a question about what Littlejohn or Goldman, Sachs said, he could simply ask Ralph and Everett and they could clarify any possibly misleading statement. Thus Joseph had a right as a shareholder to know about corporate developments, but there was no offsetting need to protect other shareholders and investors from potentially misleading disclosure. *Cf. Staffin*, 672 F.2d at 1205-07. We therefore decline to apply the "price and structure" rule of *Greenfield* in this case.

Although we agree with the appellee that preliminary merger negotiations may be material when there is no public market for the company's stock, we disagree with his suggestion that a more subjective standard of materiality applies when the corporation is closely-held.[3] *TSC*

[3] The appellants argue that the district court erred by applying a subjective standard of materiality when it ruled on appellants' motion for a judgment notwithstanding the verdict or a new trial. We agree that the district court applied an inappropriate test of materiality. Nevertheless, the court correctly instructed the jury with the objective test of materiality

(Footnote continued on following page)

Industries teaches that the test of materiality is always an objective one. 426 U.S. at 445; *see also Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963). Even with the objective test, however, the fact that the corporation is small and closely-held may affect the materiality of an omitted fact in two respects. First, an event of a given magnitude probably has a larger potential impact on the fortunes of a small company than on the fortunes of a large one. *See SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976). In addition, what the reasonable shareholder considers important is necessarily a function of his options. The "total mix" of information available to the reasonable shareholder includes the probability of being locked into a minority interest of an unprofitable, closely-held corporation. *See, e.g., Thomas v. Duralite Co.*, 524 F.2d 577, 581, 584-85 (3d Cir. 1975)(defendant gave plaintiff the impression that the company faced imminent disaster). Thus, although we apply the objective standard of materiality, the significance the reasonable shareholder would give a particular omitted fact depends on the circumstances confronting him. *See TSC Industries, Inc.*, 426 U.S. at 449 ("a substantial likelihood that, *under all the circumstances*, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder") (emphasis added); *see also* 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 61.02[b][ii], at 3-131 (2d ed. revised December, 1984) ("the hypothetical reasonable man should be presumed to be standing in the plaintiff's shoes").

On January 27, 1976, Joseph had only two options—he could sell his stock to the Company for three hundred dollars per share or he could hope that some outside entity

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[3] *continued*

and applied the subjective standard only when ruling on the motion for a j.n.o.v. *See infra* pp. 23-24. Since we hold that the district court could not have granted a judgment notwithstanding the verdict under the objective standard, the district court's error is not a reversible one.

would buy Hyman-Michaels at a higher price. If Joseph had decided not to sell and no other company acquired Hyman-Michaels, Joseph would have been the unemployed owner of a minority interest for which there was no market and that paid no dividends. *See* Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 Minn. L. Rev. 1, 37-38 n.118 (1982) (discussing the "essentially unmarketable character of minority interests in close corporations"). We therefore must consider whether the withheld information about Littlejohn and Goldman, Sachs would have assumed actual significance in the deliberations of the reasonable shareholder owning such a minority interest.

The defendants argue that no jury reasonably could find that Hyman-Michaels's contacts with Goldman, Sachs and Ralph's conversations with Angus Littlejohn were material facts for purposes of Rule 10b-5. We agree that the contact with Goldman, Sachs was not a material fact. Viewing the evidence in the light most favorable to Joseph, as we must, the evidence supports a finding that Ralph and Everett sent Charles Aaron to Goldman, Sachs to discuss (without revealing Hyman-Michaels's identity) whether Goldman, Sachs would be interested in finding a buyer for a small, closely-held company. In addition, Ralph told Angus Littlejohn that Ralph and Everett were considering retaining Goldman, Sachs to find a buyer for Hyman-Michaels. Nonetheless, on January 27, Aaron had not revealed Hyman-Michaels's identity to Goldman, Sachs and Goldman, Sachs had no way to assess the Company's salability. We therefore hold that the withheld information about the contact with Goldman, Sachs was immaterial as a matter of law.

On the other hand, a jury could reasonably find that Littlejohn's agreement to contact prospective buyers on behalf of Hyman-Michaels was material. Viewing the evidence in the light most favorable to the plaintiff, Ralph and Everett knew that Angus Littlejohn, who had visited the Company with John Samuels in September, 1975 when

Samuels discussed the possibility of ICM buying Hyman-Michaels for $12 to $14 million, had agreed to contact some prospective buyers on behalf of Hyman-Michaels. Ralph's comment that Littlejohn should "get [his] ducks lined up," together with Littlejohn's actions after the January 24 meeting,[4] support a finding that Ralph retained Littlejohn as a broker on January 24, 1976. Furthermore, although Ralph thought his conversations with Littlejohn were important enough to report to Everett and the other Company officers and advisors who met on January 26, 1976, neither Ralph nor Everett told Joseph, the only other major stockholder, about these developments.[5] See *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 851 (2d Cir. 1968) ("[A] major factor in determining whether the [information] was a material fact is the importance attached to the [information] by those who knew about it."), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). Finally, Ralph and Everett refused Joseph's request that the stock purchase agreement be signed on January 27 but the closing be delayed six weeks so that Joseph might be able to complete his negotiations with the Harris Bank and buy the Company from Ralph and Everett. They did not, Ralph testified, want to give Joseph an extension that "might interfere with any future plans [they] may have for the sale of Hyman-Michaels." In short, a jury could reasonably find that on January 27 Ralph and Everett knew—but did not disclose to Joseph—that the prospects for selling Hyman-Michaels were the brightest since the Commercial Metals negotiations had collapsed. To the reasonable shareholder standing in Joseph's shoes, this would clearly be a material fact.

The defendants also argue that the withheld information was immaterial as a matter of law because Joseph knew that Hyman-Michaels was for sale and he knew that Ralph had gone to Europe to "stir up" interest in Hyman-

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[4] *See infra* pp. 20-21.

[5] There were other stockholders besides Ralph, Everett, and Joseph, but Ralph and Everett controlled the stock of these other stockholders.

Michaels. Ralph had promised, however, to tell Joseph of any developments in Europe. In light of this promise, we think a reasonable shareholder would interpret Ralph's failure to mention any developments—especially since Al Moeng told Joseph that "nothing" happened in Europe—as a sign that Ralph had no success. This fact distinguishes the present case from *Hassig v. Pearson*, 565 F.2d 644, 649-50 (10th Cir. 1977). In *Hassig*, the Tenth Circuit held that the majority shareholder of a bank need not disclose general inquiries about purchasing the bank since he told the minority shareholder that he (the majority shareholder) was thinking about retiring and selling his majority interest. *Id.* at 649. Thus in *Hassig* the majority shareholder disclosed that he intended to end his many years as majority owner and officer of the bank and sell his interest. Here Ralph and Everett disclosed neither their proposed change in approach (using Littlejohn as a broker) nor the prospects that Littlejohn would contact on behalf of Hyman-Michaels. Knowledge that Hyman-Michaels was for sale would not aid the reasonable shareholder's deliberations if the shareholder did not know about the change in approach or the brightened prospects.

The defendants' reliance on *James Blackstone Memorial Library Association v. Gulf, Mobile and Ohio Railroad*, 264 F.2d 445 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959) is also misplaced. In that case, minority shareholders complained that the majority shareholder failed to disclose its intent to sell some of the company's assets at a favorable price. *Blackstone* was unique, however, in that the company had leased all its assets to another company in perpetuity. In exchange, the lessee promised to pay an annual dividend of seven dollars per share on the lessor's stock. The special master found, and this court agreed, that even if the minority shareholders had not sold their stock, they would still receive only the seven dollars annual dividend and would not have enjoyed any increase in the value of their stock. *Id.* at 452-53. Since the sale of assets would have no effect on the value of the stock, knowledge of the prospective sale would not alter the "total mix" of

information considered by the reasonable shareholder. In contrast, the shareholders of Hyman-Michaels would —and did—enjoy the profits of selling the Company's assets for more than their book value.

For these reasons, a reasonable jury could find that, under all the circumstances, there was a substantial likelihood that the withheld information about Littlejohn would have assumed actual significance in the deliberations of the reasonable shareholder. *TSC Industries*, 426 U.S. at 449. The defendants were therefore not entitled to a judgment notwithstanding the verdict on the ground that no reasonable jury could find the omission material. *Selle v. Gibb*, 741 F.2d 896, 900 (7th Cir. 1984).

B.

To prevail on a section 10(b) or Rule 10b-5 claim, a plaintiff must also prove scienter—an intent to deceive. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976). Since defendants argue that there was no evidence of scienter, we examine the record to determine whether a jury could reasonably find that Ralph and Everett knowingly or recklessly withheld (or misstated) material information. *See Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792-93 (7th Cir. 1977).

The defendants argue there was no evidence of scienter because Ralph thought the bank said "no" and because Ralph and Everett did not think the withheld information about Littlejohn was important. We quickly dismiss the first argument because Ralph testified at trial that Simons (the Continental Bank loan officer) told him the bank would not loan the $3 million or the $4 million unless Ralph gave a personal guarantee. Ralph also testified that he told Everett the bank wanted Ralph's personal guarantee but only told Joseph that the bank said "no" and that Joseph was "out" of Hyman-Michaels. Since the evidence clearly supported a finding that Ralph knowingly misstated the bank's answer, a jury could reasonably infer

that Ralph intended to deceive Joseph with the falsehood. *Cf. Sanders*, 554 F.2d at 792.

The plaintiff also offered sufficient evidence for a jury to find that the defendants possessed scienter with respect to the omissions. Ralph thought his discussions with Littlejohn were important enough to report to Everett and the Company's lawyers at their January 26 meeting. Nonetheless, neither Ralph nor Everett mentioned Littlejohn when they met with Joseph to buy his stock on January 27.

A finding of scienter is also supported by Ralph and Everett's refusal on January 27 to extend the closing date beyond January 30. True, it is the date the parties sign the agreement, not the closing date, that is relevant for determining materiality and scienter. *See Radiation Dynamics*, 464 F.2d at 891. But their refusal to extend the closing date and the subsequent explanations of that refusal are relevant to prove their intent on January 27, 1976. Ralph and Everett knew that Joseph and Fuerst had met with the Harris Bank and were trying to obtain a loan so Joseph could buy Hyman-Michaels. They refused to extend the closing date because, as Ralph testified, allowing Joseph a six-to-eight week extension for the purpose of allowing Joseph to obtain financing "might interfere with any future plans" for the sale of Hyman-Michaels. Therefore, viewing the facts in the light most favorable to the plaintiff, we think a jury could reasonably find that Ralph and Everett possessed the requisite scienter when they purchased Joseph's stock on behalf of the Company. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983) (scienter can be inferred from circumstantial evidence).

C.

Finally, appellants assert that the judgment for the plaintiff must be reversed because Joseph's claim cannot satisfy the reliance element of a section 10(b) claim. The

defendants contend that Joseph failed to prove he had relied on Ralph's misstatement about the bank and that they proved that Joseph would have sold his stock for three hundred dollars a share even if he had known about Littlejohn.

When a plaintiff bases a section 10(b) or a Rule 10b-5 claim on a misrepresentation, he must prove that he was induced to act by the defendant's misstatement. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 547-48 (5th Cir.), *modified*, 650 F.2d 815 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). The defendants in this case claim that Joseph's theory of reliance is premised on a fact that was contradicted by the proof. They argue that Joseph offered no credible evidence of reliance and that he therefore cannot succeed on the misrepresentation claim. We disagree. Joseph testified at trial that he would not have agreed to sell his stock for three hundred dollars per share if he had known that Continental Bank did not say "no" to the request for a loan to buy both Everett's and Joseph's stock. In addition, Joseph's attempt to obtain financing from the Harris Bank so he could buy Hyman-Michaels—an attempt that continued until he sold his stock—suggests that Joseph believed Ralph's statement and, consequently, looked for alternative methods of protecting his minority interest in the Company. From this evidence, a jury could reasonably find that Ralph's statement that the bank said "no" was relied upon by Joseph in his decision to forego his request that his stock be bought with Everett's and instead to sell only his stock to the Company.

Turning to the withheld information about Littlejohn, we note that reliance is presumed when the plaintiff proves that the withheld information was material. *See Affiliated Ute Citizens*, 406 U.S. at 153-54; *Wright v. Heizer Corp.*, 560 F.2d 236, 249 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). A defendant can still prevent a plaintiff from recovering, however, if the defendant can prove that the plaintiff did not rely, that is, "that even if the material facts had been disclosed, plaintiff's decision as to

the transaction would not have been different from what it was." *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). In the present case, Ralph and Everett argue that telling Joseph about Littlejohn would not have affected Joseph's decision to sell because he was heavily in debt and, "having been effectively dismissed from Hyman-Michaels on January 5," without a job. The plaintiff stipulated at trial that without his job at Hyman-Michaels he was "between a rock and a hard place." In addition, the defendants introduced into evidence memos written by Joseph's banker that stated that in January, 1976 Joseph owed approximately $195,000 to the First National Bank of Chicago and approximately $50,000 to the Marina City Bank. These memos are far from the conclusive proof that the defendants claim them to be; two of these memos also stated that Joseph owned approximately $225,000 in liquid, non-Hyman-Michaels securities. Since the omissions were material, the defendants bore the burden of proving no reliance, *see Huddleston*, 640 F.2d at 548, and we do not think that they conclusively proved that Joseph had no choice but to sell his stock for three hundred dollars per share on January 27, 1976. Viewing the evidence in the light most favorable to the plaintiff, a jury could reasonably find that, even though Joseph was "between a rock and a hard place," he would have postponed signing the agreement or demanded a higher price if he had known about the contacts with Littlejohn.

III.

Appellants challenge several evidentiary rulings made by the trial court. They claim that the trial court erred in admitting (1) evidence concerning Littlejohn's activities after his luncheon meeting with Ralph Michaels on January 24, 1976; (2) telexes sent by Littlejohn to Samuels and responses by Samuels; and (3) testimony about the January 28, 1976 telephone conversation between Ralph and Littlejohn. According to defendants, all

of this evidence is irrelevant and highly prejudicial and the telexes are also inadmissible hearsay. The defendants also challenge the exclusion of some of their evidence on the damages issue.

Evidence is relevant if it has "any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401. A district court can, in its discretion, exclude relevant evidence if the probative value of the evidence "is substantially outweighed by the danger of unfair prejudice." Fed. R. Evid. 403. On appeal, we accord "great deference" to the district court's decision on admissibility. *See United States v. Medina*, 755 F.2d 1269, 1274 (7th Cir. 1985).

In the present case, the plaintiff offered evidence of Littlejohn's activities after January 24, 1976 to prove that Ralph and Littlejohn agreed at the January 24 luncheon that Littlejohn would act as a broker for Hyman-Michaels. Littlejohn's activities, the plaintiff argued, revealed that Littlejohn acted as if he were the Company's broker and are therefore consistent with Joseph's contention that Ralph and Littlejohn reached an agreement on January 24. This theory of admissibility also supports the relevance of the telex Littlejohn received from Samuels on January 26, 1976. Rather than follow Samuels's instruction to explore whether ICM could purchase Hyman-Michaels, Littlejohn instead contacted Dov Gottesman, an industrialist Littlejohn had mentioned to Ralph on January 24, 1976. Littlejohn's response to the telex thus suggests that he was more concerned with the sale of Hyman-Michaels than with any potential benefit to ICM. Consequently, we think the probative value of the evidence clearly outweighed any danger of unfair prejudice.

As for the other evidence, the January 23, 1976 telex to Samuels described Littlejohn's phone conversation with Ralph and Littlejohn's intention to establish himself as a broker for Hyman-Michaels. Thus the telex is relevant as

it shows the course of action leading up to the alleged January 24 agreement. The district court also found Littlejohn's phone conversation with Ralph on January 28, 1976 and the subsequent telex to Samuels tended to confirm or clarify the agreement made on January 24. The court concluded that even though these communications occurred after the January 27 signing of the agreement, they were relevant and admissible because they tended to make the existence of a January 24 agreement more probable than it would be without this evidence. Balancing the probative value and the danger of unfair prejudice of evidence is within the discretion of the trial court, and we do not think the court abused its discretion.

The defendants also argue that the telexes were inadmissible hearsay. At trial, the plaintiff countered that the telexes by Littlejohn were admissible under Fed. R. Evid. 801(d)(2)(D) (statement by an agent of the party) and that the January 23, 1976 telex from Samuels was not offered to prove the truth of the matter asserted. We think the telexes sent by Littlejohn after his lunch with Ralph are not hearsay because, even if a broker is not an agent for purposes of Rule 801(d)(2)(D), Littlejohn's statements concerned the possible sale of Hyman-Michaels. Viewing the other evidence in the light most favorable to the plaintiff, Ralph authorized Littlejohn to act as the Company's broker and contact Samuels and other potential buyers. Thus these telexes are statements by a person authorized to make a statement about the subject and are admissible under Fed. R. Evid. 801(d)(2)(C). Of course, the plaintiff does not claim that Ralph authorized Littlejohn to act for Hyman-Michaels on January 23, 1976, so Littlejohn's telex of that date cannot be admitted under Rule 801(d)(2)(C). But Littlejohn stated in the telex "Ralph Michaels . . . just told me" and, although he later equivocated, Littlejohn testified in his deposition (which was read at trial) that he sent the telex "immediately" after his conversation with Ralph. Therefore, although the district court did not give a reason why

he overruled the hearsay objection, the court would not have abused its discretion by admitting it as a present sense impression under Fed. R. Evid. 803(1).

Turning to the telexes from Samuels, we believe the district court correctly admitted the telex sent on January 23, 1976 and received by Littlejohn on January 26, 1976. As we noted in discussing its relevance, the plaintiff argued that the telex was offered not to prove that David Lloyd-Jacob was interested or that Samuels thought ICM should buy Hyman-Michaels but rather to show Littlejohn's response to this information. Thus the first telex from Samuels, because it was not offered to prove the truth of the matter asserted, was not hearsay. Fed. R. Evid. 801(c). The telex from Samuels to Littlejohn on January 28, 1976, which stated "Proceed with contact of Lloyd-Jacob," appears to be hearsay and not within any exception. To the extent the district court erred in admitting this evidence, we find the error harmless. Fed. R. Civ. P. 61.

Finally, the defendants argue that the district court erred in excluding evidence about events occurring after Joseph sold his stock but affecting the final liquidation value of Evra Corporation stock.[4] Plaintiff's expert, Howard Doherty, testified that a post-January 27, 1976 event, the sale of Hyman-Michaels's assets to Azcon, affected the value of Joseph's stock on January 27, 1976. The defendants then tried to ask one of their expert witnesses, Carl Ruzicka, about events occurring between July, 1976 and October, 1983 that affected the liquidation value of Evra Corporation. The plaintiff objected, claiming that Ruzicka should not be permitted to testify about expenses incurred by Evra in defending the present lawsuit. The plaintiff also contended, and the district court seemed to agree, that Joseph could not be charged with management deci-

[4] As part of the sale of assets to Azcon, Hyman-Michaels sold its name to Azcon and changed its corporate name to Evra Corporation.

sions occurring after January 30, 1976 that affected the value of the stock. The district court did, however, allow Ruzicka to testify that, after Evra Corporation liquidated its assets and liabilities, approximately $8.6 million, or $427.65 a share, was distributed to the shareholders. We think the district court did not abuse its discretion in excluding evidence of events occurring between July, 1976 and October, 1983. The court could reasonably find that the danger of confusion or unfair prejudice substantially outweighed the probative value of testimony about events occurring as late as six and one-half years after Joseph sold his stock. *See Medina*, 755 F.2d at 1274 (district court ruling is given "great deference").

IV.

Ralph and Everett argue that the trial court should have granted them a new trial. Since a motion for a new trial is addressed to the sound discretion of the trial court, we may reverse the trial court's decision only for an abuse of discretion. *See Spesco, Inc. v. General Electric Co.*, 719 F.2d 233, 240 (7th Cir. 1983).

The defendants first argue that we should reverse the district court's denial of their motion for a new trial because that court applied the more stringent judgment notwithstanding the verdict standard when ruling on their motion. As the defendants correctly point out, the court's order used the language of the j.n.o.v. standard in rejecting the defendants' argument that the withheld and misrepresented information was not material. Nevertheless, we do not believe the court erred.

The defendants flooded the district court with thirty-four reasons, not counting sub-parts, why the district court should grant a j.n.o.v. or, in the alternative, a new trial. In its order disposing of the motion, the district court stated that only a few of these numerous arguments warranted discussion. The court then summarized the defendants' argument on materiality as follows: "Defend-

ants contend the court should have ruled as a matter of law that the enumerated omissions and misrepresentations were not material to the plaintiff's investment decision." Nothing in the district court's discussion of the issue suggests that the district court denied the motion for new trial on the ground that the defendants could not meet the j.n.o.v. standard. Instead, it appears that, since the defendants stressed in their memorandum in support of the motion that the information was immaterial *as a matter of law*, the district court decided that the issue whether the true information was immaterial as a matter of law warranted discussion but that whether the verdict was against the clear weight of the evidence did not. This explanation seems especially likely since the district court used language appropriate for deciding a motion for a new trial in discussing the defendants' arguments that inconsistent verdicts, inflammatory comments in closing argument, and an excessive damage award necessitated a new trial. It seems highly improbable that in one order the district court would apply the wrong standard for a new trial motion in discussing the first issue and then apply the correct standard for the remaining issues. We believe the district court concluded that the defendants' argument for a new trial did not justify discussion. Having reviewed the record, we conclude that there was evidence sufficient to support a finding of materiality and therefore the district court did not abuse its discretion in denying the defendants' motion for a new trial on this ground. *See Rey v. City of Fredericktown, Missouri*, 729 F.2d 1171, 1174 (8th Cir. 1984).

Nor did the district court abuse its discretion in rejecting the defendants' arguments that inconsistent verdicts and inflammatory comments in closing argument mandated a new trial. The district court instructed the jury that Hyman-Michaels Company was responsible for any act or omission of an officer or employee within the scope of his employment. The jury verdicts against Ralph and Everett but in favor of the Company were consistent,

as the district court reasoned, because the jury could have found that Ralph and Everett acted for their personal benefit and not in their corporate capacities. Evidence that the Hyman-Michaels Board of Directors never passed a resolution concerning the consent agreement or authorizing Marvin Chapman to reject Joseph's proposals on January 4, 1976 and January 27, 1976 supports this conclusion.

As to the alleged inflammatory comments by plaintiff's counsel in closing argument, the comments do not constitute fundamental trial error and therefore defense counsel's failure to object precludes the defendants from assigning the comments as error. *See Gonzalez v. Volvo of America Corp.*, 752 F.2d 295, 298 (7th Cir. 1985). As we stated in *Gonzalez*, "risky gambling tactics such as [not objecting] are usually binding on the gambler." *Id.* This is especially true in the present case, since the defense counsel not only failed to object but also said in his opening argument that Joseph had "abandoned and deserted" his first wife and called Joseph "sly, avaricious, and greedy" in both his opening and closing arguments. The defendants gambled on a trial strategy and lost, and the district court did not abuse its discretion in refusing to grant a new trial for comments to which the defendants did not object.

Finally, the defendants argue that the plaintiff offered no credible evidence to support the jury's award of $750,000 in compensatory damages and $200,000 in punitive damages. Howard Doherty, the plaintiff's damages expert, testified that he estimated the value of Joseph's stock as $1,823,011, or $915,928 more than Joseph received. He obtained this estimate by starting with $9,397,490, the book value (or shareholders' equity) for common stock and convertible debentures. To this figure he added the gain on the sale of assets to Azcon ($3,391,486) and the actuarial value of Ralph's and Everett's lifetime employment contracts with Azcon ($382,681). Doherty testified that under this approach Joseph's stock was worth $600.27 a share rather than the $300 he received.

The trial court stated in its order denying the motion for a new trial that the "court, and apparently the jury, found plaintiff's expert to be credible in arriving at a damage figure." True, the jury awarded $750,000 rather than the $915,928 Doherty estimated, but the jury was not bound by Doherty's estimate and was entitled to make its own estimate of damages. In any event, the verdict does not suggest "a runaway jury or one that lost its head" and therefore the district court did not abuse its discretion in denying a new trial on compensatory damages. *See Grunenthal v. Long Island Railroad*, 393 U.S. 156, 160 (1968); *Spesco*, 719 F.2d at 240-41.

With respect to punitive damages, the defendants argue that the court should not have submitted the issue to the jury because the record contains no credible evidence of willful and wanton conduct. We disagree. Under Illinois law, the function of punitive damages is to punish the wrongdoer and deter both him and others from committing like offenses in the future. *See Kelsay v. Motorola, Inc.*, 74 Ill. 2d 172, 188, 384 N.E.2d 353, 360 (1978). Thus Illinois courts have long recognized that punitive damages are appropriate when torts are committed with fraud or actual malice or when the defendant acts willfully or with a wanton disregard for the rights of others. *Id.* at 186. In the present case, the plaintiff offered evidence showing, among other things, that Ralph lied to Joseph about the bank loan, that Joseph was "out" of Hyman-Michaels as far as Everett and Ralph were concerned, that Everett and Ralph withheld information about Angus Littlejohn, and that Everett and Ralph refused to give Joseph more time to negotiate a loan so Joseph could buy the Company. If believed, this evidence supports a finding that Everett and Ralph intentionally defrauded Joseph and justifies an award of punitive damages. *See Durant v. Surety Homes Corp.*, 582 F.2d 1081, 1088 (7th Cir. 1978) ("the transcript of a trial in a fraud case will seldom reveal admissions by the defendant that his conduct was not only fraudulent but intentionally, willfully, or recklessly so"). Therefore the district court

properly submitted the issue to the jury and the court did not abuse its discretion in denying the motion for a new trial. We similarly refuse to substitute our judgment for that of the jury. *See McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 474 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

V.

Prejudgment interest is a form of compensation and the decision to award prejudgment interest rests in the sound discretion of the district court. *See Myron v. Chicoine*, 678 F.2d 727, 733-34 (7th Cir. 1982); *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1075 (7th Cir. 1975), *vacated and remanded on other grounds*, 425 U.S. 929 (1976). That decision requires a balancing of the equities between the parties under the circumstances of the particular case. *Myron*, 678 F.2d at 734. In the present case, defendants challenge the award of prejudgment interest on the grounds that Joseph is responsible for part of the delay and that a juror stated in an affidavit that the $750,000 award included prejudgment interest.

The defendants suggest that the court should not have assessed interest against them for the time between Joseph's loss and the date he filed his complaint in this lawsuit. They cite no case authority for this proposition, however, and our research has uncovered no cases. Indeed, this court has awarded prejudgment interest from the date of the loss. *See Sundstrand*, 553 F.2d at 1051; *see also Sanders*, 524 F.2d at 1075 ("unless the plaintiff is paid interest for the entire time that he is deprived of the use of his money, he will not receive full compensation"). Although Joseph did wait more than two years before filing his complaint, the district court specifically found that "the extended delay [more than eight years] between the loss and final judgment was not caused by any dilatory tactics by the plaintiff" and that there were "no countervailing equitable considerations making the award unfair to the defendants." A plaintiff's delay in filing an action, and the reason for the delay, may be considered by

the district court when balancing the equities and awarding prejudgment interest. In the present case, we believe the district court properly balanced the equities and did not abuse its discretion in awarding prejudgment interest from the date of Joseph's loss.

The defendants also challenge the district court's refusal to consider a juror's affidavit that said the jury had included prejudgment interest in the $750,000 compensatory damages award. Defendants argue that, since an award of prejudgment interest is based on fairness and equitable considerations, the district court should have considered the affidavit. We disagree.

Rule 606(b)[7] of the Federal Rules of Evidence precludes a juror from testifying about jury deliberations. This rule was designed to protect the jury's deliberative process—including jurors' statements, mental and emotional reactions, and votes. Fed. R. Evid. 606(b); *Wiedemann v. Galiano*, 722 F.2d 335, 337 (7th Cir. 1983). As the Supreme Court stated, if jurors were competent to impeach their verdict, they "would be harassed and beset by the defeated party in an effort to secure from them evidence of facts which might establish misconduct sufficient to set aside a verdict." *McDonald v. Pless*, 238

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[7] That rule provides as follows:

> Upon an inquiry into the validity of a verdict or indictment, a juror may not testify as to any matter or statement occurring during the course of the jury's deliberations or to the effect of anything upon his or any other juror's mind or emotions as influencing him to assent to or dissent from the verdict or indictment or concerning his mental processes in connection therewith, except that a juror may testify on the question whether extraneous prejudicial information was improperly brought to the jury's attention or whether any outside influence was improperly brought to bear upon any juror. Nor may his affidavit or evidence of any statement by him concerning a matter about which he would be precluded from testifying be received for these purposes.

Fed. R. Evid. 606(b).

U.S. 264, 267-68 (1915). We recognize that if the affidavit is true the plaintiff will receive an undeserved bonanza in the form of the district court's award of prejudgment interest. Nevertheless, we believe that allowing a juror's affidavit to influence a district court's opinion on prejudgment interest presents much the same problem as permitting an affidavit to support a motion for a new trial—a context in which we have already held a juror's affidavit to be incompetent under Rule 606(b). *See Wiedemann*, 722 F.2d at 337. The defendants' attempt to characterize part of the $750,000 as prejudgment interest is in essence an attempt to impeach the award; therefore the district court properly refused to consider the affidavit. *See Wilsmann v. Upjohn Co.*, 572 F. Supp. 242, 244-45 (W.D. Mich. 1983) (juror's affidavit not considered by court when awarding prejudgment interest).

VI.

Finally, the defendants claim that the district court should not have directed a verdict for the plaintiff on Hyman-Michaels's counterclaim. That counterclaim, which alleged that by bringing the present lawsuit Joseph had breached ¶ 7 of the January 27, 1976 agreement, sought damages to compensate the Company for the cost of defending the present action.

Although the parties agreed during trial not to offer evidence as to the amount of attorneys' fees incurred, the January 27, 1976 agreement was entered into evidence. That agreement only stated that Joseph released the Company "from any and all obligations, claims, demands, liabilities, actions, and causes of action" which Joseph then had; it made no mention of attorneys' fees or costs in the event of a breach. This omission is fatal to the Company's counterclaim since, under Illinois law, attorneys' fees and the ordinary expenses of litigation are not allowable to the successful party absent a statute or contractual agreement. *See Kerns v. Engelke*, 76 Ill. 2d 154, 166-67, 390

N.E.2d 859, 865 (1979); *Qazi v. Ismail*, 50 Ill. App. 3d 271, 273, 364 N.E.2d 595, 597 (1977). Therefore the district court properly directed a verdict for the plaintiff on the Company's counterclaim. *Cf. Ferrara v. Collins*, 119 Ill. App. 3d 819, 825, 457 N.E.2d 109, 113 (1983).

VII.

For the foregoing reasons, we affirm the awards of $750,000 in compensatory damages and $200,000 in punitive damages. Since we affirm these awards on the bases of the Rule 10b-5 and common-law fraud claims,[8] we need not discuss the defendants' challenges to the jury verdict on the fiduciary duty count. We also affirm the award of prejudgment interest and the directed verdict for the plaintiff on the counterclaim. The judgment of the district court is

AFFIRMED.

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[8] The defendants direct no arguments specifically to the common-law fraud count and so we presume that they would urge reversal of the fraud count for the same reasons they offer for reversal of the section 10(b) count. Under Illinois law, the elements of a cause of action for fraud are the following: (1) a false statement of material fact, (2) known or believed to be false by the party making the statement, (3) an intent to induce the other party to act, (4) action by the other party in reliance on the truth of the statement, and (5) damage to the other party as a result of that reliance. *See Soules v. General Motors Corp.*, 79 Ill. 2d 282, 286, 402 N.E.2d 599, 601 (1980). Omission of a material fact, when accompanied by scienter, deception, and injury, can also constitute fraud under Illinois law. *See Perlman v. Time, Inc.*, 64 Ill. App. 3d 190, 195, 380 N.E.2d 1040, 1044 (1978). For the reasons given in our discussion of the section 10(b) count, we hold that a jury could reasonably find the defendants liable for common-law fraud.

Nos. 84-1631, 84-1714 31

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Clerk of the United States Court of Appeals for the Seventh Circuit

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JUDGMENT—ORAL ARGUMENT

United States Court of Appeals

FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

July 3, 1985

Before

HON. HARLINGTON WOOD, JR., Circuit Judge
HON. JOEL M. FLAUM, Circuit Judge
HON. WESLEY E. BROWN, Senior District Judge*

JOSEPH MICHAELS,

Plaintiff-Appellee,

Nos. 84-1631 and 84-1714

vs.

RALPH MICHAELS, EVERETT MICHAELS and HYMAN-MICHAELS COMPANY,

Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 78 C 3274

Stanley J. Roszkowski, *Judge*

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

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* The Honorable Wesley E. Brown, Senior District Judge for the District of Kansas, is sitting by designation.

UNITED STATES DISTRICT COURT,
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Name of Presiding Judge, Honorable Stanley J. Roszkowski

Cause No. 78 C 3274 Date: April 13, 1984

Title of Cause Michaels v. Michaels

Brief Statement
of Motion

ORDER

The rules of this court require counsel to furnish the names of all parties entitled to notice of the entry of an order and the names and addresses of their attorneys. Please do this immediately below (separate lists may be appended).

Defendants' motion for a hearing on their respective counterclaims is denied. Plaintiff's motion for a directed verdict on defendants' counterclaims is granted.

During the course of the action giving rise to the instant counterclaims, counsel for the defendants stipulated that the only damages sought in the counterclaims were the fees and expenses of this litigation. (Tr. 1382) The general rule applicable to cases such as this, however, provides:

> Attorney fees and the ordinary expenses and burden of litigation are not allowable to the successful party in the absence of an agreement or stipulation *specifically authorizing* the allowance of attorney fees, or in the absence of a statute providing for the taxing of attorney fees against the losing party. (emphasis added) *Child* v. *Lincoln Enterprises, Inc.*, 51 Ill. App. 2d 76., 83., 200 N.E. 2d 751 (4th Dist. 1964)

UNITED STATES DISTRICT COURT,
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ORDER

In *Child,* the court refused to allow the defendant to recover attorney's fees for defending a personal injury action commenced by a plaintiff with whom it had previously entered into a covenant-not-to-sue.

In the present action, the January 27, 1976 agreement for the sale of stock upon which defendants premise their counterclaims provided, in relevant part:

> Joseph hereby releases the company. . . . and Everett and Ralph, individually, and their respective heirs. . . . of and from any and all obligations, claims, demands, liabilities, actions, and causes of actions . . .

The agreement did not, however, provide what remedies would be available to the parties in the event of a breach. In particular, it did not specifically authorize the recovery of attorney's fees or litigation expenses.

In the present case, neither the agreement or a relevant statute permits the recovery of the attorney's fees and litigation expenses sought in the defendants' counterclaims. In the absence of such authority, the American Rule is strongly against the recovery of such damages. *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375 (1970). Thus, plaintiff's motion for a directed verdict is allowed and defendants' motion for a hearing on the instant counterclaims is denied.

Finally, in order to avoid any confusion, the court views it as appropriate to mention the November 9, 1983 judgement order declaring "(t)here is no just reason for delay to enforce this judgement." There is no doubt that the language of that order was chosen at the direction of this court pursuant to

UNITED STATES DISTRICT COURT,
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ORDER

Federal Rule of Civil Procedure 54(b). It plainly goes beyond the requirements of Rule 58. Thus, the court deems it unnecessary, as has been suggested by the plaintiff, to correct the order pursuant to Rule 60(a) to note that the language was chosen "upon the express direction of the court." The court does not view Rule 54(b) as requiring the recitation of such language. The order is plain upon its face.

Reserve space below for notations by minute clerk

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JOSEPH M. MICHAELS,

Plaintiff,

vs.

No. 78 C 3274

RALPH MICHAELS,
EVERETT B. MICHAELS, and
EVRA CORPORATION, an
Illinois corporation,

Defendants.

ORDER

Before the court is defendants, Ralph and Everett Michaels', motion for judgment notwithstanding the verdict and, in the alternative, for a new trial. Also before the court is plaintiff, Joseph Michaels', motion for pre-judgment interest. For the reasons set forth herein, defendants' motion is denied and plaintiff's motion is granted.

I.

DEFENDANTS' MOTION

The present motion was made subsequent to a jury verdict in favor of the plaintiff in a 10b-5 and common law fraud action. The action arose out of the sale of stock in a closely held corporation. Despite the great number of errors alleged by the defendants, thirty-four apart from sub-parts, the court finds only a few as warranting any discussion.

A. Duty of Disclosure

A large number of the errors complained of by the defendants concern the issue of materiality. Defendants contend the court erroneously allowed the jury to consider whether the defendants failure to inform the plaintiff of conversations with a London broker, Angus Littlejohn, their intention to retain an investment broker, Goldman, Sachs and Co., and their failure to properly explain the reasons for the Continental Bank's termination of loan negotiations with Hyman-Michaels, were material omissions and misrepresentations. Defendants contend the court should have ruled as a matter of law that the enumerated omissions and misrepresentations were not material to the plaintiff's investment decision.

The cases cited by defendants mainly concern open-market transactions involving large publicly held corporate securities. If the present case had arisen in that context, the court would have had little difficulty in determining that the alleged omissions and misrepresentations were not, as a matter of law, material. The instant case, however, arose in the context of a closely held corporation.

In the open market context, the court agrees with the defendants that information must be rather fully developed before it may be considered material. As the district court in *Staffin v. Greenberg*, 509 F.Supp. 825 (E.D. Pa. 1981), *aff'd.* 672 F.2d 1196 (3rd Cir. 1982) explained, "public disclosure of tentative, indefinite, and contingent facts would itself be misleading. *Susquehanna Corp. v. Pan American Sulpher Co.*, 423 F.2d 1075, 1084-85 (5th Cir. 1970)." *Id.* at 836. For example, investors could well be induced to speculate on tentative information which they do not possess the knowledge or experience to place in a proper perspective. As the appellate court noted in *Staffin*, such public disclosures could prove harmful as investors acting upon such information could be "left 'holding the bag' on a stock whose value was inflated purely by an inchoate hope." *Id.* at 1207.

Such dangers are generally not present in a closely held corporation. There, stockholders generally possess greater knowledge concerning the condition and prospects of the corporation. Thus, they are better able to appreciate the significance that even tentative, indefinite and contingent facts may hold.

In a slightly different context, one commentator noted a distinction drawn between open-market purchases and face to face transactions, stating:

> A looser or more subjective [test of materiality] may also be proper in direct-personal transactions because of the greater ability of one party to appreciate the position of the other. [This] proposition has found some judicial acceptance. In an open-market case, information had to be rather fully developed before it became material, while in the direct-personal one, very tentative information was material. Bromberg & Lowenfels; *Securities Fraud & Commodities Fraud*, § 8.3 (1983).

This distinction was recognized by the court in *Thomas v. Duralite Company, Inc.*, 524 F.2d 577 (3rd Cir. 1975). In *Thomas*, the defendants failed to reveal what the court characterized as "nascent negotiations" and "vague allusions to a possible merger" to the seller of stock in a closely held corporation. The appellate court affirmed the trial court's finding of a material omission, holding that it was "not unreasonable to *assume* that more specific negotiations were deliberately postponed until after the arrangements to purchase the [plaintiff's] stock had been completed." (Emphasis added). In affirming the trial court, the appellate court noted:

> . . . [I]t is not difficult to accept the necessity for a clearly enunciated objective standard when the 10b-5 suit affects a large number of shareholders who may have no direct or continuing contact with the corporation. But when the scene shifts to a situation where a single purchaser who is well known to the seller actively conceals facts, the distinction between objective materiality and subjective reliance becomes obscured.

In the present case, the defendants do not contend that the court improperly instructed the jury on the elements of a 10b-5 or fraud action. Nor do the defendants contend the court improperly instructed the jury on the definitions of the key elements of those cause of actions. Defendants merely renew their contention that the court should have ruled as a matter of law that alleged omissions and misrepresentations were not material, arguing the evidence did not support the jury's findings.

In ruling upon a motion for judgment nothwithstanding the verdict, the evidence and all reasonable inferences therefrom are to be viewed in a light most favorable to the prevailing party. *Hohmenn v. Packard Instruments Co., Inc.*, 471 F.2d 815, 819 (7th Cir. 1973); *Gass v. Gamble-Skogmo, Inc.*, 357 F.2d 215, 217 (7th Cir. 1966), *cert. denied*, 384 U.S. 943 (1966). In the present case, the jury could have reasonably inferred that the defendants were aware that Littlejohn had a likely purchaser in mind prior to the plaintiff's commitment date. As the plaintiff pointed out, Ralph Michaels was sufficiently excited about his meeting with Littlejohn to convene a special meeting with Everett Michaels and Hyman-Michaels' attorney the day after he returned from Europe. The defendants convened this special meeting despite the fact that they were scheduled to meet as a board *with the plaintiff* a day or so later. Moreover, the defendants refused to extend the date for the sale of the plaintiff's stock and confirmed their arrangement with Littlejohn immediately after the commitment date.

Direct admissions of fraud are rare indeed. *Durant v. Surety Homes Corp.*, 582 F.2d 1081, 1088 (7th Cir. 1978). The jury must determine from the facts and circumstances what the defendants knew and whether it would have been material to the plaintiff. In light of all the facts revealed in the record, the court cannot conclude that the evidence and all reasonable inferences therefrom do not support the jury's verdict.

Similarly, there was ample evidence from which the jury could have concluded Ralph Michaels misrepresented the reason for Continental Bank's refusal to extend a loan to Hyman-Michaels. The plaintiff testified that Ralph Michaels told him his request that his Hyman-Michaels stock be purchased along with Everett Michaels' stock could cause the Continental Bank to refuse to make any loan to Hyman-Michaels. Later, Ralph Michaels told the plaintiff that the bank had refused the loan—when there was evidence that it had not. Under the circumstances, there was ample evidence from which the jury could find Ralph Michaels had misrepresented the status of the loan. Moreover, the jury was entitled to determine this misrepresentation was material to the plaintiff's investment decision.

Finally, the jury could have determined, in the context of a closely held corporation, that the defendants' failure to inform the plaintiff of their intention to retain an investment banker was material. Any of the three alleged omissions and misrepresentations could have been found to be material by the jury. Thus, in light of the presumption in favor of the jury's verdict and the evidence introduced by the parties, the court finds the defendants' contention based upon the insufficiency of the evidence to be without merit.

B. Consistency of the Verdicts

Defendants also contend the verdicts entered by the jury are inconsistent. Defendants cite the fact that they were held liable for violating the securities laws while Hyman-Michaels was not. Moreover, defendants point out that the jury found the company was not guilty of violating a warranty with respect to the purchase of the plaintiff's stock. The warranty provided: "the company is not and at the time of closing will not be in violation of any laws . . . laws to which it is subject."

The court finds no inconsistency in the verdicts. There is no automatic liability imposed upon a corporation when its

agents or majority stockholders commit a violation of the securities laws. *Thomas v. Duralite Company, Inc.*, 524 F.2d 577, 586 (3rd Cir. 1975); *Rochez Bros. Inc. v. Rhoades, II*, 527 F.2d 880, 884 (3rd Cir. 1975). The court cannot rule as a matter of law that the evidence failed to support a finding that the defendants were acting as individuals for their own account and that the plaintiff knew the defendants were not acting for the corporation. *Id.*

The purchase of the plaintiff's stock, while technically done through the corporation, was solely for the personal benefit of the defendants. Indeed, it is difficult to imagine any benefit derived by the corporation from the purchase. In a closely held corporation, the actors are able to distinguish the personal and corporate motives of the officers and stockholders even when their actions are technically made on behalf of the corporation. Here, the evidence supports the jury's apparent finding that the defendants, while technically acting in their corporate capacities, were not acting on behalf of the corporation, but were acting as individuals for their own account. Moreover, this fact was no doubt apparent to the plaintiff as one of the three principal stockholders in the closely held corporation. Thus, in the present context, the court finds no inconsistency between the jury's verdict against the defendants and in favor of Hyman-Michaels on the securities count.

Similarly, the court finds no inconsistency between the jury's verdict against the defendants on the securities count and in favor of Hyman-Michaels on the warranty count. The court does not construe the subject warranty as insuring against the acts of third parties acting on their own behalf. The jury apparently concluded, consistent with the securities count, that the defendants were acting as third parties simply attempting to advance their own interests. Under the circumstances, the court finds no inconsistency in the verdict of the jury.

C. Damages

Defendants contend the jury's verdict can find no basis in law or fact and is the product of improper statements by counsel for plaintiff. Defendants object that plaintiff's counsel improperly informed the jury in opening statement that they should compensate the plaintiff for the loss of the use of any money damages they awarded from the date of the sale. After the defendants objected, however, plaintiff's counsel stated ". . . whether you are asked to calculate that or whether the judge does it will be decided later. If I misspoke, I apologize to [defendants' counsel] and to you." The defendants did not object to plaintiff's counsel's explanation, nor move for a mistrial. Moreover, pre-judgment interest was not included as an element of damages in the jury instructions and was not argued in summation. Under the circumstances, the court finds counsel's statement does not warrant a new trial.

Similarly, the court does not view the jury's verdict as improper under the law or facts. The parties agree that the jury was properly instructed as to the appropriate measure of damages. The jury was instructed the measure of damages was the difference between what the seller received for his stock and what he would have received had there been no fraudulent conduct. *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 155 (1971); *Myzel v. Fields,* 386 F.2d 718, 748 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

Applying this measure of damages, the court cannot conclude the jury's verdict was improper. The court, and apparently the jury, found plaintiff's expert to be credible in arriving at a damage figure representing the difference between the actual value of the stock at the time it was sold and the selling price. Defendants' argument that this was improper because the amount that plaintiff would have received had there been no fraudulent conduct was the amount ultimately obtained in the sale was for the jury to accept or reject. Plaintiff did not testify that he would have permanently re-

tained his stock, but for the fraud. He merely testified he would not have sold for that price. Thus, applying the above test of damages, the jury was entitled to conclude what the plaintiff would have received had there been no fraud was the actual value of the stock at the time it was sold. The other objections raised by the defendants merely go to the credibility of the plaintiff's expert and were considered by the jury.

Finally, defendants contend that an award of punitive damages was not supported by the evidence. Defendants do not raise any objection to the manner in which the jury was instructed on the issue of punitive damages. Thus, the award can only be set aside if the court determines, from the manifest weight of the evidence, that it was wholly unwarranted. *Durant v. Surety Homes Corp.*, 582 F.2d 1081, 1087 (7th Cir. 1978).

As the court in *Durant noted,* "*[i]n the nature of things, the transcript of a trial in a fraud case will seldom reveal admissions by the defendant that his conduct was not only fraudulent but intentionally, willfully or recklessly so.*" *Id.* at 1088. Here, as in *Durant,* the "jury was surely free to disbelieve (the defendants') understandably self-serving assertions . . ." *Id.* Defendants' basic contention is that they knew nothing prior to the commitment date. The jury was certainly entitled to disregard these self-serving assertions based upon their observation of the witnesses' credibility and the objective facts. Among the objective facts were Ralph Michaels' discussions with Littlejohn, the convening of the special meeting between the defendants immediately upon Ralph Michaels return from his discussions with Littlejohn, the refusal of the defendants to grant the plaintiff any additional time in which to agree to the sale of his stock, and the rapidity with which events occurred once the plaintiff was committed to the sale. Finally, defendants expressly confessed their desire to punish the plaintiff for his lack of loyalty. Thus, the court finds no basis for disturbing the jury's award of punitive damages.

II.

PLAINTIFF'S MOTION

Plaintiff seeks pre-judgment interest from the date of the sale to the date of the judgment. Both sides agree that the award of pre-judgment interest under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78J (1981), is within the sound discretion of the court. *Rolf v. Blyth, Eastmen, Dillon & Co., Inc.*, 637 F.2d 77 (2d Cir. 1980); *Sanders v. John Nuveen & Co., Inc.*, 524 F.2d 1064 (7th Cir. 1975), *vacated on other grounds*, 425 U.S. 929 (1976). In determining whether to award pre-judgment interest, the court must consider the relative equities. *Id.* at 1075.

In the present case, the court views the award of pre-judgment interest as appropriate. Here, as in *Sanders*, the jury determined plaintiff suffered the loss of the use of the money he would have received, but for the defendants' fraud. The extended delay between the loss and final judgment was not caused by any dilatory tactics by the plaintiff. And, there are no countervailing equitable considerations making the award unfair to the defendants.

Defendants' principal argument in opposition to the award of pre-judgment interest rests upon their contention that the jury already considered pre-judgment interest in awarding damages to the plaintiff. In support of their contention, defendants attach the affidavit of a single juror indicating the jury's verdict included an award of pre-judgment interest.

Plaintiff moves to strike the affidavit on the basis of Federal Rule of Evidence 606(b). Rule 606(b) provides, in relevant part:

> *Upon an inquiry into the validity of a verdict*. . . a juror may not testify as to any matter or statement occurring during the course of the jury's deliberations . . . except that a juror may testify on the question of whether extraneous

> prejudicial information was improperly brought to the jury's attention or whether any outside influence was improperly brought to bear upon any juror. . . . (emphasis added).

Defendants contend Rule 606(b) is inapplicable because the subject affidavit was not offered to contest the *validity* of the verdict, but merely to demonstrate the unfairness of awarding pre-judgment interest in the present case.

Even assuming the defendants are correct in urging that Rule 606(b) is inapplicable to the present case, the court does not believe the subject affidavit should be considered in ruling upon the plaintiff's motion. In the notes accompanying proposed Rule 606(b), the Advisory Committee noted:

> Under the federal decisions the central focus has been upon insulation of the manner in which the jury reached its verdict, and the components of deliberation, including arguments, statements, discussions, mental and emotional reactions, votes, and any other feature of the process. Thus, testimony or affidavits of jurors have been held incompetent to show a compromise verdict . . . a quotient verdict . . . misinterpretation of instructions . . . [and] mistake in returning verdict. . . . (citations omitted).

While the terms of Rule 606(b) may not expressly apply to the facts of the instant case, the court believes the objectives of the rule, insulating the manner in which the jury reaches its verdict and insulating individual jurors from harrassment, justify disregarding the affidavit presented in the instant case. To hold otherwise would allow a party to invade the decision making process of the jury for any number of collateral issues not directly challenging the "validity" of the verdict. For example, a litigant might well attempt to challenge an award of attorney's fees in a civil rights action with an affidavit of a juror asserting that fees had been included in the jury's award. Thus, plaintiff's motion to strike the Beardsley affidavit will be allowed.

The final issue with respect to pre-judgment interest is the rate of interest to be allowed. In accordance with the court's decision in *Durant*, the court deems the appropriate rate of interest to be the statutory rate for judgments in Illinois. Moreover, consistent with this, the court does not consider it appropriate to compound the award of pre-judgment interest. Thus, in the view of the court, the appropriate amount of pre-judgment interest in the present case is $468,750.00.

III.

COSTS

The plaintiff is allowed $71.00 for witness fees and expenses, $15.00 for court fees, $500,00 for photocopying and $2,304.51 for deposition costs (Fuerst, Littlejohn and Everett, Joseph and Ralph Michaels). The total costs awarded the plaintiff pursuant to 28 U.S.C. § 1920 are $2,890.51. Thus, the total amount of the judgment is $1,421,640.51.

ENTER:

Stanley J. Roszkowski, Judge
United States District Court

Dated: March 22, 1984

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JOSEPH M. MICHAELS,

Plaintiff,

vs.

No. 78 C 3274

RALPH MICHAELS,
EVERETT B. MICHAELS and
HYMAN-MICHAELS COMPANY,

Defendants.

ORDER

Before the court is defendants' Motion to Reconsider this court's decision denying defendants' Motion for Summary Judgment. For the reasons set forth herein, the Motion to Reconsider is denied.

The facts and arguments of the parties have already been set forth in the court's order denying summary judgment. The court denied summary judgment because there remained genuine issues of material fact, including factual disputes concerning (1) the circumstances surrounding Continental's rejection of Hyman-Michaels Company ("H-M") loan proposal, and (2) the conversations at the January 24, 1976 meeting between Ralph Michaels and Angus Littlejohn, and the inferences to be drawn from them.

I. Misrepresentation Regarding Continental Bank's Refusal to Make the Requested Loan

Joseph Michaels ("Joseph") claims that Ralph Michaels ("Ralph") made a material misrepresentation by stating that

the request for an additional $1 million caused the bank to terminate negotiations. Joseph claims that this led him to believe that $300 per share was the most H-M could pay for his stock, and he claims that the real reason the bank terminated negotiations was because Ralph refused to give his personal guarantee, a pledge of H-M stock, or an insurance policy on Ralph's life.

Defendants argue in their Reply Memorandum and in their Motion to Reconsider that Joseph's deposition testimony shows that, on or shortly after January 5, 1976, neither Ralph nor anyone else told Joseph the results of Ralph's negotiations for the bank loan. Hence, they claim that no misrepresentation was made.

At one point in his deposition testimony, Joseph indicated that he was never told that the bank had turned down the loan, and did not find out about it until he read depositions in this litigation. Hence, his deposition testimony does appear to contradict his claim that Ralph falsely represented to him that the request for the additional $1 million was the reason for the bank's refusal of the loan. However, in plaintiff's Response to Defendants' Reply, plaintiff cites passages from *Ralph's* deposition which suggest that Ralph *did* tell Joseph at least that the bank had turned down the loan. While Joseph's statements during his deposition may well bear on his credibility at trial, in view of Ralph's deposition testimony, we cannot rule out the possibility that Joseph may have misunderstood the line of deposition questioning or may otherwise be able to explain his deposition testimony. Because the allegations in Joseph's pleadings are not inconsistent with the record, they must be taken as true, and the court is therefore in no position to find that there is no genuine issue of material fact with respect to whether any misrepresentation was made concerning the reason for the denial of the bank loan. *Goodman v. Mead Johnson & Co.*, 534 F.2d 566 (3rd Cir. 1976), *cert. denied*, 429 U.S. 1038 (1977).

Defendants claim in their Reply Memorandum in support of their summary judgment motion that Ralph made it clear before the $1 million *piggy* loan to buy Joseph's stock was sought that he would not provide security for the loan. Whether this was made clear to Joseph will depend upon whether Joseph's story or Ralph's story is believed, and such questions for credibility are clearly questions for the trier of fact.

II. Omission of Material Fact Concerning the Conversation Between Ralph Michaels and Angus Littlejohn

The court also denied summary judgment because there remained a genuine issue of material fact as to the substance of the conversations between Ralph and Angus Littlejohn and as to the inferences to be drawn therefrom.

According to plaintiff, on January 23, 1976, while Ralph was in London, he telephoned Angus Littlejohn and told him that since negotiations with Commercial Metals had terminated, H-M was on the market. Ralph asked if ICM was still interested in H-M, and since Littlejohn knew that ICM and other companies were interested in H-M, he persuaded Ralph to stay in London an extra day to discuss the sale of H-M. At a lunch with Ralph on January 24, 1976, Littlejohn mentioned a number of companies that he thought might be interested in acquiring H-M, including Consolidated Gold Fields ("Consolidated"). Consolidated, through its acquired subsidiaries Brown-Strauss and Union Steel, had done joint venture business with H-M previously, and plaintiff claims Ralph knew of the relationship between these companies and Consolidated. Moreover, Consolidated's executive director, David Lloyd-Jacobs, who was responsible for the acquisitions program of Consolidated, had toured certain H-M facilities previously.

The court recognizes that plaintiff has only limited evidence that defendants' failure to disclose the conversation between Ralph and Littlejohn was an omission of material fact.

There is no direct evidence that Littlejohn had received indications from Consolidated or any of the other companies that they were currently interested in acquiring H-M, let alone of the price they would be willing to pay. Nevertheless, the facts, together with inferences favorable to plaintiff, suggest that Littlejohn made it his business to keep apprised of companies that might be in the market for companies such as H-M. In his opinion, Consolidated, which had in 1974 inspected certain H-M facilities and had a history of acquiring companies similar to H-M, might still be interested in acquiring H-M. Although the reason for calling the meeting is in dispute, it is arguable that Ralph was excited enough about the possibility of an acquisition by Consolidated or one of the other companies named by Littlejohn to convene a meeting of Everett and company lawyers immediately upon his return to Chicago to relate the results of his meeting with Littlejohn.

Given these facts and inferences, the court finds itself unable to conclude, as a matter of law, that there was not a "substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The court's decision that it cannot conclude that these facts and inferences are not material is bolstered by the Supreme Court's statement that determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are *peculiarly ones for the trier of fact.*" *Id.* at 439 (emphasis added).

The cases cited by defendants do indicate that, at least under some circumstances, the entry of summary judgment may be appropriate where only preliminary negotiations for acquisition have begun. Here, however, we have additional circumstances which render summary judgment inappropriate. The

defendant's did not inform plaintiff that they had sought to retain Goldman, Sachs to find a buyer for the company, and that Goldman, Sachs had expressed interest in acting as a broker for H-M. While the court does not attach significance to the fact that defendants sought to retain Goldman, Sachs, the fact that a prominent investment banking firm apparently viewed H-M as a company marketable enough to express interest in having H-M as a client may itself be a factor to which a reasonable investor would attach actual significance.

As demonstrated by the discussion above, there remain genuine issues of material fact as to the rejection of the loan proposal and the conversation between Ralph and Littlejohn and the inferences to be drawn therefrom. The motion for reconsideration of the court's order denying summary judgment is therefore denied.

ENTER:

Stanley J. Roszkowski, Judge
United States District Court

Dated: December 15, 1982

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JOSEPH M. MICHAELS,

Plaintiff,

vs.

RALPH MICHAELS,
EVERETT B. MICHAELS and
HYMAN-MICHAELS COMPANY,

Defendants.

No. 78 C 3274

ORDER

Before the court in this action for securities fraud under Section 10b of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. § 78j, and Rule 10b-5, 17 C.F.R. § 240.10b-5, is defendants' Ralph Michaels ("Ralph"), Everett Michaels ("Everett"), and Hyman-Michaels Company ("H-M") motion for summary judgment. For the reasons hereinafter stated the motion is denied.

Jurisdiction is based on Section 27 of the Act, 15 U.S.C. § 78aa.[1] The remaining counts arise under principles of common law fraud and equity and jurisdiction is based on pendent jurisdiction.

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[1] Section 27 of the Act, 15 U.S.C. § 78aa provides:

> The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules

The plaintiff, Joseph M. Michaels ("Joseph"), is the nephew of defendants Ralph and Everett. From 1949 until January 30, 1976, Joseph worked for H-M. At all relevant times prior to Janua[illegible] 30, 1976, Joseph was the Executive Vice President, a Director, and the registered owner of approximately fourteen per cent of the outstanding common stock of H-M.

Defendant Ralph was the President, Chief Operating Officer, a Director and owned or controlled approximately thirty-six per cent of the outstanding common stock of H-M.

Defendant Everett was Chairman of the Board of Directors, Chief Executive Officer and owned or controlled approximately fifty percent of the outstanding stock of H-M.

Defendant H-M was at all relevant times, an Illinois corporation, with its principal place of business in Cook County, Illinois. Prior to July 8, 1976, H-M owned and operated, among other things, a business which purchased, processed and distributed scrap iron and steel. On July 8, 1976, H-M sold substantially all the business assets and goodwill of its scrap business, including the name H-M to Azcon Corporation ("Azcon"). Azcon is a wholly owned American subsidiary of Consolidated Gold Fields, Ltd. ("Consolidated"), a United

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and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act ot transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, and 1292 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

Kingdom corporation, with its principal office in London, England. As part of the transaction, the unsold assets and business of H-M were reincorporated as Evra Corporation ("Evra"). Evra was voluntarily dissolved on June 29, 1977.

The facts of the case are as follows. From approximately the late 1960's to July 1976, H-M investigated the possibility of selling its assets or stock. In the Fall of 1975, H-M negotiated with International Carbon and Minerals Corporation ("ICM") for a potential acquisition of H-M. Negotiations, however, broke down in December 1975. At this time, Ralph decided that H-M would attempt to buy out Everett's stock holdings in H-M at $300.00 per share. To do so, Ralph began negotiations with Continental Bank ("Continental") for a three million dollar loan. Joseph then became concerned with his minority position at H-M, when it appeared that Ralph and his family were to be the sole majority stockholders. At a meeting on January 4, 1976, Joseph, through his attorney, made various proposals to Ralph and Everett to protect his minority position. In the alternative, Joseph proposed that H-M buy his stock as well as Everett's shares in H-M. Ralph rejected all proposals, except for the possibility of buying Joseph's entire interest in H-M. To effectuate this purpose, Ralph agreed to seek an additional one million dollar loan from Continental. The Bank, however, refused to lend either the three million dollars originally requested or the four million dollars subsequently sought, unless the loan were secured by Ralph's personal guaranty, the pledge of an insurance policy on Ralph's life, or the pledge of certain shares of H-M. Ralph refused to accept a loan on these terms.

On January 5, 1976, the day on which Continental rejected any unsecured loan proposal, Ralph and Everett decided to purchase Joseph's stock and terminate Joseph's employment with H-M. On January 27, 1976, Joseph, Everett and Ralph on behalf of H-M, entered into an Agreement under which Joseph agreed to sell to H-M all his stock at $300.00 per share. Joseph

further agreed to deliver the stock to H-M on January 30, 1976, at which time his employment with H-M would terminate.

In the Agreement, H-M warrants to Joseph that the purchase of the stock is not in violation of any corporate or other law to which H-M is subject. In addition, the Agreement contains a release, which purports to release H-M, and Ralph and Everett from "any and all obligations, claims, demands, liabilities, actions and causes of action", which Joseph may then have had or may have against H-M, its subsidiaries, their directors, employees, agents, and Everett and Ralph individually.

Approximately six months later, on July 8, 1976, Consolidated, through Azcon, acquired the scrap iron division of H-M for approximately $13.4 million.

On August 16, 1978, plaintiff filed a five count complaint naming Ralph, Everett, Evra, Azcon and Consolidated party defendants. In his complaint, plaintiff alleges the defendants misrepresented and omitted material facts about the potential sale of H-M with an intent to deceive and defraud plaintiff in connection with his sale of H-M securities. Plaintiff alleges these acts violate § 10b of the Act, 15 U.S.C. § 78j and Rule 10b-5, 17 C.F.R. § 240.10b-5.[2] Plaintiff, invoking pendent jurisdiction, also alleges in separate counts common law fraud, fraud in the inducement, breach of contract and warranty.

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[2] Section 10b of the Act, 15 U.S.C. § 78j provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Plaintiff bases his cause of action on events which occurred around the time he sold his securities to H-M in January 1976. First, plaintiff claims that Ralph made material misrepresentations to him with respect to the termination of loan negotiations with Continental. Joseph asserts that Ralph told him the request for an additional one million dollar loan caused the Bank to terminate negotiations. Joseph claims, however, that it was Ralph's refusal to personally guarantee the loan, which caused the negotiations to end. As a result of this material misrepresentation, Joseph believed that $300.00 per share was the maximum price that H-M could afford to pay for the stock.

Second, plaintiff claims that defendants began negotiations for a potential takeover in January 1976 and omitted to disclose that fact to Joseph prior to his sale of stock. Specifically, Joseph claims that on January 24, 1976, Ralph met with Angus

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(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Littlejohn, a consultant to ICM in London, England and discussed the possible takeover of H-M. Several buyers were suggested, including ICM and Consolidated. On January 28, 1976, Ralph spoke by telephone with Littlejohn and indicated a preference to pursue Consolidated for a potential acquisition of H-M.

Plaintiff asserts that these two events marked the beginning of the negotiations which culminated in the July 8, 1976 sale of H-M. Joseph, therefore, claims that at the time he signed the Sale Agreement on January 27, 1976, Ralph and Everett knew that "there existed a substantial likelihood or at least a reasonable prospect of an acquisition of H-M's stock or assets." Further, Joseph claims that he did not know and in the exercise of due care could not have known that there was any such acquisition prospect. Had he known of a potential sale, Joseph alleges he would not have signed the Agreement on January 27, 1976, nor delivered his H-M shares for the price received on January 30, 1976.

On January 12, 1981, plaintiff filed an amended complaint (the "complaint"), in which he named Ralph, Everett, and the pre-July 8, 1976 Hyman-Michaels and the Evra Corporation (hereinafter jointly ("H-M") party defendants. In the four count complaint, plaintiff alleges material misrepresentation and omissions with intent to defraud under Section 10b and Rule 10b-5. Plaintiff bases Ralph and Everett's liability on their positions as "controlling persons" of H-M within the meaning of Section 20(a) of the Act, 15 U.S.C. § 78t(a).[3] Plaintiff claims that H-M is liable as purchaser of the stock and perpetrator of Ralph and Everett's alleged unlawful conduct. In Counts II and III, plaintiff invokes pendent jurisdiction,

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[3] A controlling person is defined as

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally

bringing counts of breach of fiduciary relationship and common law fraud against Ralph and Everett. Plaintiff brings Count IV against H-M for breach of contract and warranty.

Plaintiff seeks $1,600,000.00 in damages, which equals the difference between the sum received for the sale of the securities, $910,860.00 and their alleged actual value of approximately $2,500,000.00 on January 27, 1976, plus interest. Additionally, plaintiff seeks $200,000.00 in punitive damages and such further relief as the court deems appropriate including costs and reasonable attorneys' fees.

In their answers to the complaint, defendants entered a general and specific denial of plaintiff's allegations. Defendants also claim as an affirmative defense that plaintiff signed a release which constitutes a complete bar to this action. Defendants claim further that none of the information allegedly omitted was material to any investment decision of plaintiff. Alternatively, if such information was material, defendants argue, plaintiff knew or should have known of its omission and could have ascertained the information upon reasonable inquiry. Finally, defendants assert that they acted in good faith and had no knowledge of any fraudulent, false or misleading activities or statements.

On December 3, 1981, defendants filed a motion for summary judgment. In support of their motion, they assert that there are no material issues of fact. They agree that the events, upon which plaintiff bases his cause of action occurred, but assert that the inferences drawn by plaintiff are erroneous and that any alleged misrepresentations and omissions would not

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with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Section 20 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78t(a).

have been material to the exercise of a reasonable investor's decision to sell his stock. Specifically, defendants claim that Ralph and Everett made their decision to buy plaintiff's stock and terminate his employment, before the Bank rejected H-M's loan application. Ralph, therefore, denies plaintiff's allegations that he induced Everett to side with Ralph in order to oust Joseph from the company and denies that they forced Joseph to sell at a price lower than the stocks actual value.

Additionally, defendants assert that their January 24, 1976 meeting and January 28, 1976 telephone conversation with ICM's agent were immaterial and irrelevant to Joseph's decision to sell his H-M stock. First, defendants claim that Joseph himself initiated the sale on January 4, 1976, when his attorney presented proposals to either protect Joseph's minority position in H-M or arrange for the purchase of Joseph's 14% interest in the company.

Defendants further claim that on January 24 and 28, 1976, they knew little of the structure of Consolidated and were unfamiliar with Azcon. Consequently, negotiations were at such a preliminary stage defendants allege there was no duty to inform Joseph.

As for the pendent state claims, defendants urge that the undisputed facts establish that they are not liable under Illinois law for alleged breach of fiduciary duty and common law fraud. They assert that even if a genuine issue of fact exists with respect to materiality and reliance, plaintiff acted recklessly in failing to investigate and that plaintiff must be held to have released defendants from any claim in this case for failure to make reasonable inquiry when he executed a release on January 27, 1976.

In response to the motion for summary judgment, plaintiff asserts that there are numerous genuine issues of material fact in dispute between the parties. Plaintiff claims that the motion for summary judgment is inappropriate and, therefore, must be denied.

To recover in a private action for damages under § 10b and Rule 10b-5, plaintiff must allege that "defendants wilfully or recklessly made material misrepresentations or omitted to communicate material facts." *J. H. Cohn & Company v. American Appraisal Associates, Inc.*, 628 F.2d 994, 998 (7th Cir. 1980). Additionally, plaintiff must establish that the alleged misrepresentations and omissions meet the test of materiality under subsection (b) of Rule 10b-5. This test is "an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445, 96 S.Ct. 2126, 2130 (1976). In other words

> . . . there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available. 426 U.S. at 449, 96 S.Ct. 2133 (footnote omitted).

Next, plaintiff must allege that he relied to his detriment upon the misrepresentations or omissions. The burden of proof, however, varies depending upon whether the Section 10b action is based on fraud by misrepresentation or omission. In a case where the defendant misrepresents a material fact, the plaintiff must establish reliance. *Issen v. GSC Enterprises, Inc.*, 508 F.Supp. 1278 (N.D. Ill. 1981). On the other hand, where plaintiff alleges fraud based on omissions, reliance is presumed, once plaintiff establishes materiality. *Sundstrand Corporation v. Sun Chemical Corporation*, 553 F.2d 1033, 1048 (7th Cir. 1977), *cert. denied* 434 U.S. 875. The burden then shifts to the defendant to conclusively establish nonreliance. *Issen, supra.*

Plaintiff must also establish that the misrepresentations were made "in connection with the purchase or sale of any security." Rule 10b-5, 17 C.F.R. § 240.10b-5. The "in connection with" requirement need not occur before the consummation of a purchase or sale. There must, however, be "some temporal relationship between the events and the purchase of stock." *Issen v. GSC Enterprises, Inc.*, 508 F.Supp.

1278, 1286 (N.D. Ill, 1981) (citing *Clinton Hudson & Sons v. Lehigh Valley Co-op Farms,* 73 F.R.D. 420, 425 (E.D. Pa.), *aff'd. mem.* 586 F.2d 834 (3d Cir. 1977). The Seventh Circuit, in *Goodman v. Epstein,* 582 F.2d 388 (7th Cir. 1978), *cert. denied* 440 U.S. 939 (1979), stated that "so long as an investment decision remain(s) to be made upon any possible state of facts, the nondisclosure (is) in connection with the purchase (or sale) of a security." 582 F.2d at 413.

In their motion for summary judgment, defendants claim that they are entitled to judgment as a matter of law because the alleged misrepresentations and omissions were not material to plaintiff's decision to sell his H-M securities.

Rule 56, Federal Rules of Civil Procedure, provides that the court shall enter summary judgment if the "pleadings, depositions, answers to interrogatories, and admissions on file together with the affidavits if any show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Particularly relevant to the instant case is the well settled fact

> . . . Summary judgment under Rule 56 should be granted only where it is perfectly clear that there is no dispute about either the facts of the controversy or the inferences to be drawn from such facts.

Central National Life Insurance v. Fidelity & Deposit Company of Maryland, 626 F.2d 537, 539 (7th Cir. 1980).

In the instant case, the parties dispute both the basic facts of the case and the inferences which may be drawn from the facts. Among the disputed facts are the circumstances surrounding Continental's rejection of H-M's loan proposal and the impetus for the termination of Joseph's employment at H-M. In addition, the substance of the conversations at the January 24, 1976 meeting between Ralph and Littlejohn and in the subsequent telephone conversation are disputed, as are the inferences to be drawn from these conversations. Finally, the relationship between these two events and the subsequent sale of H-M in July 1976 is also unclear.

Summary judgment, therefore, is particularly inappropriate, where as here, the issues before the court center around the materiality of the alleged misrepresentations and omissions to plaintiff's decision to sell his H-M stock. Materiality presents a mixed question of law and fact. *McGrath v. Zenith Radio Corporation,* 651 F.2d 458, 466 (7th Cir. 1981), *cert. denied* 102 S.Ct. 136 (1981). In *McGrath,* the Seventh Circuit stated

> . . . the determination (of materiality) requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these facts to him, and these assessments are peculiarly ones for the trier of fact. 651 F.2d at 466.

On a motion for summary judgment, there must be no genuine issue of material fact and the court must accept the truth of the facts presented by the party opposing the motion. *Essary v. Railroad Yardmasters of America,* 87 F.R.D. 727, 728 (N.D. Ill. 1980). Where evidence raises doubts as to an issue of material fact, it is construed in favor of the opposing party. 87 F.R.D. at 728. Defendant then bears the burden of establishing that no genuine issue of fact exists. In the instant case, it cannot be said as a matter of law that defendants have met their burden.

Accordingly, it is ordered that defendants' motion for summary judgment be and the same hereby is denied.

ENTER:

Stanley J. Roszkowski, Judge
United States District Court

Dated: July 15, 1982

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 84-1631
84-1714

JOSEPH MICHAELS,

Plaintiff-Counterdefendant-Appellee,

v.

RALPH MICHAELS, *et al.*,

Defendants-Counterplaintiffs-Appellants.

On Appeal from the United States District Court for the Northern District of Illinois

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MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN CONNECTION WITH PENDING PETITION FOR REHEARING AND SUGGESTION OF REHEARING IN BANC

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MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN CONNECTION WITH PENDING PETITION FOR REHEARING AND SUGGESTION OF REHEARING IN BANC

The Securities and Exchange Commission submits this memorandum as amicus curiae to urge this Court to modify or delete the dictum in its July 3, 1985 decision which states that, under the federal securities laws, merger negotiations by publicly held corporations, where there has not yet been an agreement on price and structure, are not material and therefore need never be disclosed to the company's shareholders (Slip op. at 9-11). Such a test is contrary to the Commission's

long-standing position, traditionally accepted by the courts, that in many cases such merger negotiations may become material at a far earlier stage. This Court's views, although dictum, relate to a matter of major importance in the administration and enforcement of the federal securities laws, and could have a serious adverse impact on investor protection.

Although we urge a standard of materiality different from that expressed in the Court's dictum, it is not necessary for this Court to decide which standard is correct. Since this case involves merger negotiations by a private, closely held corporation, this Court's dictum regarding negotiations by public companies is not necessary to its decision, and could simply be deleted. The Commission does not take a position here on the Court's holding that the merger negotiations by the private company in this case were a material event that had to be disclosed. Thus, the modification or deletion in the July 3 decision that the Commission urges would not require alteration of this Court's judgment.

DISCUSSION

1. This Court, in stating that merger negotiations by a public company are never material until there is agreement on price and structure, accepted the view of materiality adopted by the Third Circuit in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985).[1] The Commission is of the view that the *Greenfield* test of materiality

[1] The Third Circuit had previously held in *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982), that merger negotiations do not become material until an agreement in principle has been reached, but did not specify until *Greenfield* that the point of agreement occurs when agreement has been reached on price and structure. The Commission disagrees with the statement in *Staffin* that merger negotiations never become material prior to an agreement in principle.

is far too rigid, is inconsistent with prior decisions in this area, and would deprive shareholders in public companies of important information relevant to their investment decisions.

In considering this issue, it is important to note by way of background that a company *is under no general obligation in all cases to disclose even material merger negotiations to its shareholders.* A duty to disclose material information only arises in certain situations, most of which are within the corporation's own control, such as in this case where a duty to disclose arose only because the company chose to buy its own stock. Thus, adopting a broader view of materiality than that suggested in *Greenfield* would not require disclosure of merger negotiations in all cases. Disclosure would only be required in certain situations.[2]

Information about a corporation is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision regarding the company's stock. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). It has long been established that the determination of when an uncertain event,

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[2] In addition to the situation where the company is trading in its own stock, a company may have to disclose merger negotiations in filing certain Commission disclosure documents, such as Schedule 14D-9, which requires disclosure of merger discussions undertaken in response to a tender offer. 17 C.F.R. 240.14d-101, Item 7. Disclosure may also be required where the company makes a public statement which would be false or misleading without disclosure of the merger discussions, or where the company is aware that word of the discussions has already leaked from the company into the market. Thus, in general, if a company is not responding to a tender offer, does not trade in its own stock, and neither issues a public statement about corporate developments nor is responsible for word leaking into the market, it need not disclose even material negotiations. *See generally* Block, Barton & Garfield, *Affirmative Duty to Disclose Material Information Concerning Issuer's Financial Condition and Business Plans*, 40 Bus. Law. 1243, 1244-55 (1985).

such as a possible merger, is material depends on the facts of the particular case, and that in the case of a merger, the discussions may become material well before there is agreement on price and structure. The importance of such uncertain events to a reasonable shareholder "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company's activity." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), the court rejected the defendants' contention that merger negotiations, which were far removed from agreement on price or structure, were not "material because the possibility of a merger was always remote." *Id.* at 1305. In finding the merger negotiations material, the court noted that, even though they "had not jelled to the point where a merger was probable," the merger would, if it occurred, have a great impact on the company. *Id.* at 1306-07.

The Second Circuit reiterated this approach in *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976). In finding early merger talks in that case, which were far away from agreement on price or structure, to be material, the court (Friendly, J.) noted the *Texas Gulf Sulphur* test or materiality, and said that "the application of this test implies that there is '[no] specific rule as to when information respecting a merger becomes material,' but rather indicates that each case must be approached on its own facts." *Id.* at 47, quoting *SEC v. Shapiro*, 494 F.2d at 1306. *Accord, Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 131-34 (S.D.N.Y. 1984).[3]

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[3] The Commission has recently reiterated its long-standing view that merger discussions may become material well before agreement is reached on price and structure. *See In re Carnation Co.*, Sec. Act. Rel. No. 22214 (July 8, 1985), reprinted in [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,801.

In contrast to this factual approach, the bright line "price and structure" test adopted in *Greenfield* is unrealistic.[4] The materiality of merger negotiations varies according to how important the merger would be to the company, and the negotiations may become material well before there is agreement on price and structure. The proposed acquisition of a company is likely to be far more significant, and be considered material far earlier, to the acquired company's shareholders than almost any other event. As the court observed in *Geon*, "[s]ince a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a matter of that sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high." 531 F.2d at 47-48.[5]

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[4] In our view, the Second Circuit did not abandon its traditional approach in *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983). We believe that *Reiss* must be read as limited to its facts. The court did not purport in *Reiss* to overrule its clear statement in *Shapiro* and *Geon* that merger talks may in some circumstances become material well before their fruition. Indeed, the *Reiss* court did not even cite *Geon*, *Shapiro* or *Texas Gulf Sulphur*. Since one panel may not overrule the decision of another panel of the same court, *see, e.g., In re Jaylaw Drug, Inc.*, 621 F.2d 524, 527 (2d Cir. 1980); *United States v. Fatico*, 603 F.2d 1053, 1058 (2d Cir. 1979), *cert. denied*, 444 U.S. 1073 (1980), this Court should not assume that the *Reiss* court intended to do so *sub silentio*. It is noteworthy that the lower courts in the Second Circuit have not read *Reiss* as overruling its earlier cases, and have continued to hold merger negotiations material even where no agreement on price and structure has been reached. *See SEC v. Gaspar*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 133 (S.D.N.Y. 1984).

[5] Although Judge Friendly was speaking in *Geon* of a "small" corporation, the acquisition of a large corporation could equally be "the most important event that can occur in" the large corporation's life.

An excellent example of how even early merger talks can be material is provided by *SEC v. Gaspar,* [Current] Fed. Sec. L. Rep. (CCH) ¶92,004 (S.D.N.Y. 1985), in which the court found that preliminary talks by an oil company with a potential acquiror were material to the company's shareholders, even though they fell through without agreement on price or structure. In finding the talks material, the court noted that announcement of the preliminary talks by the company had sent its stock soaring by over 40%, on greatly increased volume, in little over one day. *See id.* at 90,971, 90,977-78. Thus, it is plain that even early talks can have a significant effect on investment decisions. The reason for this is that mergers are often consummated at a significant premium per share over market price. Even after discounting for the risk that the merger will not occur, the possibility of such a premium can be a significant factor in the investor's decision to buy, sell or hold the stock.[6]

2. The Third Circuit in *Greenfield* did not dispute that disclosure of preliminary merger negotiations could have a significant influence on investor decisions. It nonetheless found such negotiations not to be material for two reasons, neither of which is supportable.

a. The first concern was that, as this Court summarized it, there is a "need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations" (slip op. at 10, citing *Greenfield,* 742 F.2d at 14). The concern is, in

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[6] This Court characterizes trading on the basis of such information as "speculative investment" and appears to suggest that such investment is an undesirable practice to be prevented (slip op. at 11). There is, however, nothing necessarily improper in speculative investment based on an assessment that a change in control may or may not take place. In fact, a subspecialty of professional traders, the risk arbitrageurs, make their living precisely by assessing the risk that such changes in control will or will not occur, and investing accordingly. These trading activities are often critical to the success of tender offers, and can help to promote the liquidity of the capital markets.

effect, that it is impossible for a corporation accurately to disclose the existence of preliminary merger negotiations, and that such disclosure would thus itself be misleading. The Commission does not agree with this reasoning. As noted, the obligation to disclose even material merger negotiations only arises in certain situations that are largely in the corporation's control, such as where it is trading in its stock or has made a public statement. *Disclosure is necessary in most cases to correct a potentially misleading situation already created by the corporation.* In such situations, it should be a relatively simple matter for a corporation to disclose that it is engaged in preliminary talks toward a possible merger, that there is no agreement to merge, and that the results of the talks cannot be predicted. For example, with respect to merger discussions undertaken in response to a tender offer, which must be disclosed on Commission Schedule 14D-9, the Commission has provided instructions as to what constitutes sufficient disclosure (see n.8, *infra*).

The view that adequate disclosure cannot be made is totally at odds with this Court's holding in this very case. This Court held that the concern about misleading a company's investors did not exist here because the plaintiff seller of the stock, with access to company management, was in a position where, if the disclosure about negotiations was ambiguous, "he could simply ask [management] and they could clarify any possibly misleading statement" (slip op. at 11). But if full and accurate disclosure can be made through management providing such supplemental disclosure, there is no reason why the management of a public company could not make accurate and unambiguous disclosure to their shareholders at the outset.

Indeed, by assuming that such disclosure could not be made to the public, this Court creates a highly unfair dichotomy between the disclosure obligations to shareholders with access to management, and the ordinary shareholder without such access. This dichotomy entitles shareholders in private corporations to greater disclosure than the shareholders in public

companies that Congress was most concerned about.[7] The anomaly would be that the private company shareholders would be entitled to this enhanced disclosure precisely because they *already* have access to management and can obtain sufficient disclosure. This view turns the securities laws on their head, providing enhanced disclosure to those who least need it. Carrying this reasoning one step further, it could be held that larger shareholders in *public* companies—institutional investors, securities professionals, and others with access to management—who also can obtain clarification of ambiguities in management's disclosures, should likewise enjoy enhanced disclosure. Indeed, everyone might be entitled to disclosure of merger talks *except* for the small and often uninformed shareholders for whom the securities laws were intended to provide particular protection. The ultimate result would be that if such information is not deemed material, insiders of the corporation could lawfully trade with the uninformed public shareholders, and realize profits at their expense, without ever disclosing this highly important information.

This result unfortunately follows from *Greenfield's* flawed assumption that management cannot make accurate public disclosure of the existence of merger negotiations. In the Commission's view, accurate public disclosure of merger negotiations can be made. The answer to any potential ambiguities in such disclosure is not to limit the right of disclosure to a privileged class of investors who can ask management to clarify their statements, but rather to have management make clear and unambiguous disclosure in the first place.

b. The *Greenfield* court's second concern was that requiring disclosure of merger talks prior to agreement on price and

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[7] As the Supreme Court has recently stated, "it is clear from the legislative history of the Securities Acts of 1933 and 1934 that Congress was concerned primarily with transactions 'in securities . . . traded in a public market' " *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2306-07 n.7 (1985), quoting *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975).

structure would inhibit such talks. *See* 742 F.2d at 757. In our view, this concern is overstated, and does not justify deeming such talks not material. In the first place, as discussed above (see p. 3), in many cases even material negotiations need not be disclosed, and many of the situations where disclosure is required—such as where the company is engaged in trading or has already made a corporate statement—are in the control of the corporation. If a company refrains from trading in its stock, and does not otherwise make statements regarding corporate developments, it should usually be able to negotiate in secrecy. Second, even if some facts regarding negotiations have to be disclosed, many details, including the identity of the other party to the talks and the precise terms discussed, may often remain secret.[8] The limited disclosure required in such cases should not ordinarily inhibit negotiations.[9] In the final analysis, however, this concern cannot justify deceptive conduct.

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[8] For example, the instructions to Item 7 of Schedule 14D-9, 17 C.F.R. 240.14d-101, state that in disclosing merger talks undertaken in response to a tender offer, "[i]f no agreement in principle has yet been reached, the possible terms of any transaction or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuation of the negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient." Although this degree of disclosure may often also be sufficient for purposes of the anti-fraud provisions of the securities laws, it should be noted that under some circumstances additional disclosure might be necessary under those provisions. *See* Sec. Act Rel. No. 6158 (Nov. 29, 1979), 18 SEC Docket 1053, 1070 (1979).

[9] *Id.*

CONCLUSION

For the foregoing reasons, the Commission urges this Court to modify or delete the dictum in its July 3, 1985 decision discussing the materiality under the federal securities laws of merger discussions by public companies.

Respectfully submitted,

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